

Department of Economic and Social Affairs

**TAX TREATIES
BETWEEN DEVELOPED
AND DEVELOPING COUNTRIES**

Fourth report



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Part One

REPORT OF THE AD HOC GROUP OF EXPERTS ON TAX TREATIES BETWEEN DEVELOPED AND
DEVELOPING COUNTRIES ON ITS FOURTH MEETING

INTRODUCTION

1. The fourth meeting of the Ad Hoc Group of Experts took place in Geneva from 4 to 15 December 1972. The following persons attended:

Carlos C. Martínez Molteni (Argentina); Carlos G. Yacomán (Chile); Helmut Debatin (Federal Republic of Germany); Pierre Kerlan (France); A. N. E. Amissah (Ghana); Ramanlal Shah (India); Simcha Gafny (Israel); Torao Aoki (Japan); W. H. Van den Berge (Netherlands); Stener Hanson (Norway); Riaz Ahmad (Pakistan); Ambrosio Lina (Philippines); Sangarapillay Sittompalam (Sri Lanka); Hamzah Merghani (Sudan); Kurt Locher (Switzerland); Ahmed Zarrouk (Tunisia); Adnan Bazer Kafaoglu (Turkey); A. H. Smallwood (United Kingdom of Great Britain and Northern Ireland); Nathan Gordon (United States of America). In addition, a number of advisers to the experts participated in the meetings. Observers from several countries, the specialized agencies, several intergovernmental organizations, and non-governmental organizations also attended the meetings.

2 The Ad Hoc Group elected the following officers: Hamzah Merghani (Sudan), Chairman; W. H. Van den Berge, (Netherlands), Vice-Chairman, A. Scheel (Norway), Rapporteur, and in his absence, F. Gendre (Switzerland), who acted as Rapporteur. Stanley Surrey acted as Special Adviser to the Rapporteur.

3. The Ad Hoc Group adopted the following agenda:

1. Royalties (leasing, film rentals, copyright royalties);
2. Dividends;
3. Exchange of information (and international tax evasion and avoidance);
4. Methods of elimination of double taxation (incentives for investment);
tax sparing and alternative measures;
5. Other problems (including non-discrimination, income from immovable property, international income allocation, etc.)

4. The list of documents is contained in annex II.

5. The representative of the Secretary-General, at the opening session, stated that the effectiveness of tax-incentive schemes introduced by most of the developing countries often depended on the interrelationship of their tax systems and those of the capital-exporting countries from which the investment originated. One area of intensified effort had to do with international tax evasion or avoidance. The representative stressed the need for world-wide economic co-operation, particularly in the area of international commercial policy, transfer of technology and joint investment ventures.

General observations

6. The observer from the International Fiscal Association (IFA) pointed out that his organization had been making great efforts during the past three years to fulfil its consultative status with the United Nations. Because of the internal organizations of IFA, an opinion on scientific matters by the Association can only be taken on resolutions adopted at its annual congresses. For practical purposes the subjects of such congresses must be selected two years in advance. Accordingly it had proved difficult to co-ordinate the IFA proceedings with the working procedures of the Ad Hoc Group. However, a procedure could be found for IFA to provide the United Nations Secretariat and the Ad Hoc Group with factual information on the subject of royalties and interest, and two reports, "Tax Treatment of the Remuneration Paid by Enterprises in Developing Countries for Technical Assistance and Licences under Patents" and "Treatment of Royalties in Tax Conventions Between Developed and Developing Countries" have now been distributed to the members of the Ad Hoc Group. IFA notes with satisfaction that the topic "Allocation of Income and Expenses", which is one of the two subjects to be discussed at its next congress, will be of interest to the Ad Hoc Group.

7. The observer from the Organization of American States (OAS) informed the Group that its Office of Public Finance had prepared an unofficial English version of Decision No. 40, adopted by the Commission of the Cartagena Agreement, the member countries of which form the so-called Andean Group. That decision approved model tax treaties for avoiding double taxation. In addition, the observer from the OAS said that copies of that translation had been made available to the Secretary for distribution to those attending the present meeting of the Ad Hoc Group.

8. The Chairman read a communication from the Secretary-General stating that, in view of the continuing financial difficulties of the Organization, some measures of budgetary restraint are unavoidable. While the extent to which the members of the Ad Hoc Group wish to associate themselves with the Secretary-General's preoccupations and policies is a matter for them to decide, the Secretary-General expressed his belief that they would wish to assist him in obtaining objectives which in his view and in present circumstances were in the best interests of the Organization.

9. The observer of the Organization for Economic Co-operation and Development (OECD) indicated that the Committee on Fiscal Affairs of that Organization had recently revised 11 articles and the commentaries thereon of the 1963 OECD Draft Double Taxation Convention on Income and Capital. ^{1/} These texts have not, at this stage, been the subject of a recommendation by the Council of that Organization and therefore did not commit member countries of that Organization. These texts were, however, de-restricted by the OECD and were circulated for information to the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries.

10. The provisional agenda was adopted.

^{1/} Organization for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital (Paris, 1963).

I. SCOPE OF ROYALTIES

11. The discussion on royalties was opened by the Special Adviser to the Rapporteur, who referred to the discussion of that topic that had taken place at the third meeting of the Ad Hoc Group of Experts. ^{2/} As summarized in paragraph 146 of the report, the general conclusion had been that both the country of source and the country of the recipient of the royalty might tax this income, with appropriate recognition of expenses involved in the production of royalties, and subject to such double taxation relief as the country of the recipient might be willing to grant; and that some accommodation between the tax claims of the two countries would normally be found.

12. The Special Adviser to the Rapporteur pointed out that the discussions of the Group at its third meeting had been limited to industrial royalties and that film rentals, copyright royalties, rentals from leases of personal property and treatment of royalties paid between affiliated companies had been held over for future discussion.

13. The Group then decided to discuss film rentals.

A. Film rentals

14. The discussion was opened by a member from a developing country, who pointed out that the question of the proper taxation of film rentals was relevant only in the absence of a permanent establishment in the source country. The basic question was whether film rentals should be taxed on a gross or net basis and what expenses should be allowed in computing the taxable income of the producer or the distributor. The member explained that, as a general proposition, his country preferred taxation on a gross basis, but was prepared to consider a reduction in the rate of tax so as to give recognition to the expenses incurred by the producer or distributor. With respect to the tax base, a member from another developing country stressed the fact that quite often an international distributor and a local distributor were inserted between the producer and the exhibitor of the picture, and that it was not unusual to hold the income of the local distributor to a low amount so that the country of source collected only a very limited tax. This raised the question of how the international distributor and the producer, who normally do not maintain a permanent establishment in the country where the film is exhibited, should be taxed, especially since the country of source could rarely if ever determine the actual amount of net income realized by those parties. The fairest solution would be for each taxable person to disclose the amount and composition of his income and its tax treatment in his own country, but it was recognized that this aim probably could not be accomplished. The member stated that his country would be prepared to give recognition to the substantial investment made by the producer and therefore set the withholding rate on gross income at a figure which would presumably match the corporate tax on net income. Without committing himself to a definite figure, the member submitted that a withholding rate of between 10 and 15 per cent might be discussed by the Ad Hoc Group.

^{2/} See Tax Treaties between Developed and Developing Countries: Third Report (United Nations publication, Sales No. E.72.XVI.4), paras. 126 through 146.

15. A member from a developed country agreed with taxation on the basis of gross income. The selection of this method could be supported on the ground that a motion picture is not generally distributed in the year it is produced; it might be three or four years old before it was exhibited in a developing country, and in the meantime expenses were being incurred in the production of new films. Under these circumstances it might be difficult for a country, including the producer's country, to make a precise determination of the expenses incurred with respect to a particular film.

16. In setting the rate of tax on gross film rentals, the experience of the producers over a period of time should be taken into account. In the member's judgement, a tax rate of 10 per cent computed on gross income would correspond to a rate of 40 or 45 per cent on net income from the exhibition of the film and would appear adequate. Indeed, a lower rate could be supported, since if most of the profits originated outside the home country full taxation by other countries would allow little or no revenue for the home country.

17. One member from a developing country referred to the somewhat similar point raised in the case of shipping profits, where the Ad Hoc Group had suggested that if two countries agreed in bilateral negotiations that shipping profits might be taxed by the source country as well as the residence country, the tax charged by the source country on its share of the enterprise's world profits should be reduced by an appropriate percentage. 3/

18. Some members from developing countries supported taxation on a gross basis, both because of the complexities of determining amortization and other expense elements and the practice of some producers or distributors to set up in developing countries subsidiaries for the exploitation of films to which only minimal income was allocated. One member referred to the Swiss draft on royalties presented during the third meeting of the Group and recommended adoption of the principles set forth there, apart from a precise rate. In brief, he thought that (a) both countries have the right to tax the income; (b) if the source country is satisfied with a tax on gross income, it must be prepared to accept a lower tax rate; (c) if countries negotiating a tax treaty agree that income should be taxed on a net basis, they should also agree in advance on the types of expenses to be considered; (d) the withholding tax on film rentals might be set as a somewhat higher rate than the rate for industrial royalties; and (e) concessions made by the source country should be matched by equivalent benefits extended by the country of residence, such as the foreign tax credit or a tax-sparing credit. The member added that perhaps a distinction should also be made between the treatment of new films and old ones, including television pictures.

19. A member from a developing country raised the question of whether the difference between taxation on gross and net bases could be sustained in the case of films that were four or five years old so that all expenses in connexion therewith had been fully amortized; if this contention was valid, a tax rate of 40 per cent on the film rentals could be justified.

20. Another member from a developed country, which is a major producer of motion picture films, pointed out that the cost and expenses of a film are undertaken in the expectation that it will be shown over a period of four or five years; the accounting of motion picture companies is usually based on such expectations.

3/ Ibid., paras. 60-64.

Moreover, even if a film is written off before it is shown in a given country, this is an indication that the deduction allowed by the home country in prior years was excessive. The excess should be recouped by the home country in subsequent years, after a film has been amortized but produces income from abroad. Therefore, just as in the case of industrial royalties which pose the same issue, the statement that gross income might be identical with net income after the passage of some time was of doubtful validity.

21. Another member from a developing country agreed that gross income from film rentals and net income were not necessarily identical. He felt, however, that unlike a licensor of industrial property, the lessor of a film was under no obligation to service the property, police the patents or make further inventions available to the licensee, and that a higher tax on film rentals would be justified on this ground. Another member from a developing country, while generally agreeing with these views, pointed out that the statutory law of his country gave consideration to the problem of gross versus net taxation by permitting a blanket reduction of 50 per cent.

22. With respect to the relative rate of tax on film rentals and industrial royalties, a member from a developed country suggested that it would be useful to consider the profit situation of the motion picture industry. In his country at least, the profits of this industry were not conspicuously greater than those of other industries, and in other countries such companies had to be subsidized by the State to be viable.

23. The Group briefly discussed the proper treatment of rentals from motion pictures that are shown only outside the country in which they are produced. Some members felt that it would be necessary to allocate at least some portion of such film rentals to the country of production, while others held that this situation was too unusual to merit detailed consideration.

24. One member from a developing country pointed out that taxation of film rentals at a comparatively high rate was justified, both because such imports were in the nature of luxuries as compared to goods of prime necessity and because motion picture companies in developed countries amortized the cost of a picture over a comparatively short period so that all income realized thereafter was pure profit.

25. Another member from a developed country called attention to the fact that the Group had discussed the treatment of industrial royalties at great length during the third meeting without arriving at definite conclusions. The member expressed himself in favour of exempting film rentals at the source, but agreed that as a practical matter there would have to be some sharing of revenue considering the experience with industrial royalties and the difficulties of finding a proper withholding rate. The member felt that the Group should limit itself to set forth the various viewpoints and arguments, but leave specific solutions to actual treaty negotiations.

26. There was some mention that motion picture rentals merited special treatment because cultural and artistic purposes rather than profit motivation were involved in the production of some films, while other members held that the production of a motion picture was a commercial venture like any other.

27. The Special Adviser to the Rapporteur suggested that there might be some misunderstanding concerning the treatment of industrial royalties. Members had agreed that recognition should be given to expenses incurred even where such expenses were written off in the residence country, and that whatever measure of taxation was adopted was essentially aimed at taxing net income only. ^{4/} The real question under discussion was not whether expenses should be considered, but how expenses should be reflected in the tax rate where a rate on gross royalties or rentals was used.

28. One member from a developing country pointed out that losses or low profits of motion picture companies were often due to the exaggerated compensation paid to prominent actors, whose income would not be taxed by the source country, and that such costs did not justify reduced taxation in the source country. In response to this statement, it was asserted by a member from a developed country that the motion picture industry was quite unlike any other in as much as the producer and actors and other participants often carried out their functions in different countries. This may facilitate tax avoidance and efforts should be made by tax administrators to see that the parties do not escape taxation by some country. However, in the taxation of the film rentals, the essential costs to be considered were those actually incurred by a producer and it is not appropriate to get at those who escape tax by imposing excessive taxes on those who do not.

Summary of the discussion by the Special Adviser to the Rapporteur

29. There was a general consensus that film rentals are not to be treated as industrial and commercial profits, but in the context of royalties on which the guidelines were given in paragraph 146 of the third report. Briefly, the tax would be on the gross amount, but expenses would be taken into account in fixing the withholding rate. In considering the matter of expense, some members pointed to factors that could be regarded as peculiarly relevant to film rentals. Thus, it was said that as a general rule the expenses of film producers may be much higher and the profits lower than in the case of industrial royalties. On the other hand, it was pointed out that a considerable part of film expenses represented high salaries paid to actors and other participants having been taxed solely by the country of residence, not shared in by the source country, and may not justify great reduction of the withholding tax at source (and these incomes need not be reached by the source country). However, it could be replied that the amounts involved were nevertheless real costs for the producer and should be taken into account, while at the same time all countries involved should join in efforts to make sure that such income did not escape tax. Further, while the write-off of expenses in the country of residence did not mean that the expenses should not be taken into account at source, at some point old films could present a different expense situation. All in all, the final result was that of a basic similarity to industrial royalties, but with recognition of special factors, such as those mentioned above, that should be kept in mind considering the element of the expenses involved in the case of film rentals.

^{4/} Ibid., para. 129.

B. Copyright royalties

30. While discussing the first item on the agenda, the Ad Hoc Group had before it a document on the scope of royalties. 5/

31. In this document a reference is made to an inquiry conducted by the Secretary-General in 1957 and 1958. At the request of UNESCO, the Secretary-General addressed a questionnaire to Governments covering the international tax treatment of authors' royalties. The replies of the Governments indicated that a number of countries, motivated by the desire to encourage cultural exchanges were prepared to give special consideration to the tax treatment of authors through administrative legislation beyond the measures of countering double taxation of such income. The replies indicated that at that time a number of countries exempted at least a portion of authors' royalties from income tax on royalties or taxed such income at a reduced rate at least in the case of royalties derived from domestic sources, under certain circumstances, e.g., royalties that were not earned in the course of a professional activity exercised through a permanent establishment.

32. It was stressed that this favourable treatment was mostly granted to authors deriving royalties directly rather than to copyright royalties paid to publishers.

33. The Ad Hoc Group discussed whether copyright royalties should be treated differently from industrial royalties or film rentals. This topic had been briefly discussed at the third meeting of the Ad Hoc Group.

34. A member from a developed country expressed himself in favour of complete exemption of cultural royalties by the source country because the country of the author's residence was in a much better position to consider the author's personal circumstances. An author might spend many years on the completion of a book, and it would be most unfair to impose a tax on the aggregate income realized in one year. Perhaps a distinction should be made between royalties which accrue to an author and those which accrue to a publisher.

35. One member from a developing country pointed out that exemption was given to copyright royalties in his country, not generally, but under some treaties concluded by his country and in exchange for other concessions. Another member from a developing country pointed out that there was no difference between income derived by an author and income derived by other persons, and that it would be difficult to exempt such royalties if, for instance, his particular country taxed even charitable organizations.

36. Another member from a developing country agreed that in principle there was no difference between the various types of income; nevertheless, in order to stimulate cultural exchanges exemption might be agreed upon in bilateral negotiations.

37. A member from a developed country stated that the article on tax exemption of professors and teachers included in all the tax conventions of his country is designed to stimulate cultural exchange, but this provision is not free from

5/ Ibid., part two, chap. III, and in particular section D.

criticism from the viewpoint of tax equity. Therefore, the member was not in favour of introducing another tax exemption at source on cultural grounds.

38. A member from a developed country pointed out the danger of fiscal evasion which might arise. However, in addition to the fiscal aspect, there were arguments to encourage cultural exchanges which had to be considered. Another member from a developing country opposed the exemption in the source country if the resident's country kept its tax. In such a case the result might be shifting the tax from the source country to the resident's country. A member from a developed country urged the tax exemption at source because the tax was levied there frequently through a withholding tax. A gross withholding tax cannot take into account the real net income of the author and might frequently exceed the foreign tax credit available to him in the developed country. A member from a developed country thought there was a difference between industrial royalties and cultural and copyright royalties. The patents from which industrial royalties are derived were usually developed by individual employees of the industrial enterprise as a part of the over-all gainful activity, while copyright royalties were frequently the result of a lifetime effort of an individual. An observer from a developing country maintained that the same tax principles should apply to cultural and industrial royalties unless for cultural reasons exemption were granted in both countries.

39. The Special Adviser to the Rapporteur summarized the principal results of the Ad Hoc Group's discussion of copyright royalties.

40. Having arrived at conclusions on the subject of industrial royalties, the Ad Hoc Group must now attempt to apply these principles to copyright royalties. Some members felt that because copyright royalties represent cultural efforts, they should be exempted by the source country. Some members, however, felt that this was merely a sentimental gesture, and that since tax would be levied by the residence country, the reduction at source would not benefit the author. Other members were in favour of exempting copyright royalties at the source, not necessarily for cultural reasons, but because the residence country is in a better position to evaluate the expenses and personal circumstances of the creator of the royalties, including the period of time over which the books were created. In this same view, in some cases a reduction of the source country's tax could be supported by the fact that this tax was too high to be absorbed by the tax credit of the residence country. However, it must be recognized that source countries may not be willing to accept this approach to the problem. Further, those contending for exemption of the royalties by the source country on cultural grounds face certain problems. The party dealing with the source country may generally be the publisher and not the author, and arguments supporting the exemption of the author's income because of his personal situation obviously do not apply to the publisher. The Special Adviser to the Rapporteur noted that the matter was not as simple as might have been assumed originally. While various viewpoints had been presented, the Ad Hoc Group reached no consensus on the exemption of copyright royalties in the source country. Perhaps it becomes a matter of preference for those source countries desiring, as an expression of the encouragement of cultural exchange, to grant the exemption as a concession in a tax treaty.

C. Leasing

41. The discussion was opened by a representative of a developed country who stated that there was a tendency to consider income from leasing an essential equivalent to royalties. The OECD model follows this approach. Others took the position that there are important similarities between a lease and an instalment sale. This approach also would preclude taxation of the rentals by the source country in the absence of a permanent establishment maintained in that country by the lessor.

42. A member suggested that perhaps leasing of property might be compared with a loan of money. Interest payments reflected in part the cost incurred by the lender. In the case of leasing, the payments made by the lessee include not only an interest factor, i.e. income from capital, but the return of the capital itself. It follows that if the tax of the source country is based on gross rental income, its rate should be considerably lower than that of the tax paid on interest.

43. A member from a developed country stated that some of the lease arrangements may in effect be disguised in instalment sales. Consequently, a recent tax treaty concluded by his country included an understanding which restricted the application of the capital gains provision to genuine alienation of property without leaving the seller any right on the property. The member also explained at some length the rulings prepared by the tax authorities of his country concerning the criteria to distinguish royalties from payments for performance of personal services or delivery of goods incidental to the use of right or property giving rise to such royalties and pointed to the necessity and usefulness of establishing the internationally acceptable rules for such differentiation.

44. A member from a developing country emphasized the fact that, unlike the case where property is sold, in a lease the ownership of the property does not pass. The question therefore was how the source country should determine the amount of taxable income. In the member's opinion, only such expenditures as are approximately related to the rental income should be treated as deductible, and the taxable proportion of total income should be considerably higher than in the case of interest. In the case of interest, an extensive study was made on the expenditures component, but no such study was available on lease rent. Since the lease involved fixed property, the situation was not as fluid as in financial transactions, nevertheless in equity a reasonable deduction should be allowed. Another member from a developing country felt that, since part of the compensation was paid for the use of the property and part constituted a return of capital, the rate of withholding tax should be held comparatively low.

45. Again, another member from a developing country referred to a paper submitted by IFA, entitled "Tax Treatment of the Remuneration Paid by Enterprises in Developing Countries for Technical Assistance and Licenses under Patents", by A. Nooteboom and J. H. Th. Schipper. On page 28 of this paper it is stated "that the continuous use of a patent or of know-how will be deemed to create such strong and permanent economic ties with the user's country that this, particularly in developing countries, is experienced as something equivalent to a physical presence of the foreign supplier in their country. For this reason there is a tendency to regard this situation particularly in the developing countries as analogous to that of a permanent establishment in the usual sense of the word".

46. An observer mentioned that there was a difference in legal traditions which might explain why some members were more ready than others to apply tax on the full leasing profits, without regard to depreciation. Whereas many countries regarded the depreciation deduction as an intrinsic element in the computation of profits, just as any other cost element, other countries, and particularly many of those sharing the British income tax traditions, tended to look upon current profits as the proper base for the income tax, and to grant depreciation allowances on a selective basis only, rather than as a matter of basic right.

47. Another observer pointed out that two different tax treatments existed in various systems; one allowed depreciation allowance to plant and business machinery only, but not in the case of residential leasing. In other systems all elements of cost were deductible.

48. The Special Adviser to the Rapporteur remarked that those countries that are prepared to tax property rentals at the source do not want to base this claim on the existence of a permanent establishment of the lessor. Hence, leasing should not be classified under industrial and commercial profits. Accordingly the Group would seem to be in favour of looking at this problem from the viewpoint of the taxation of royalties, and thus the rentals would be subject to a withholding tax on gross rentals at the source. In this approach, there also appeared to be general agreement that the expenses of the lessor should be taken into account, and the question was the determination of the expenses to be considered and reflected in the withholding rate.

49. A member from a developing country pointed out that unlike the case of industrial royalties, the cost of the leased property constituted a sum certain. Accordingly more precise reflection of expenses was called for than in the case of royalty expenses. Since various types of machinery are subject to different depreciation rates, it may still be necessary, however, to make a reasonable estimate from case to case.

50. The Ad Hoc Group also discussed the situation in which fully depreciated items of equipment were leased from a lessor in an industrial country to a lessee in a developing country. A member from an industrialized country held that the developing country should allow a reflection of cost because otherwise there would be a transfer of tax from the industrialized to the developing country. If a foreign investment produces income to the investor, but not to his Government, because the tax of the investor's home country is fully offset by the foreign tax, the investor's home country may feel that its tax policy is misdirected. For this reason, the developing countries should exercise reasonable restraint in taxing the lessor's income to prevent industrialized countries from encouraging domestic investment over foreign investment.

51. Another member from an industrialized country pointed out that a developing country would usually not attempt to tax the seller's profits from sales of imported machinery. This being so, the question arises whether a developing country should properly tax profits under a leasing agreement, considering that the lessee in the developing country has all the advantages of having the machinery work there, including the advantage (as compared to a sale) of being able to exchange machinery that has become obsolete for the most modern equipment.

52. In response, a member from a developing country pointed to the basic differences between sales and leases, turning on the transfer of ownership. He felt that the lessor's home country should receive a fair share of the tax on the

rentals, just as it would be entitled to tax on the interest on a cash loan. A member from another developing country pointed out that under the law of his country the entire income from leasing transactions was taxable, although the administration applied rules under which only the income element included in the rental payments would be taxed. It was pointed out that it might be very difficult to determine the income element included in the rental payments, and that it might be preferable as a practical matter to tax the full amount of the payments at a low rate.

53. The Special Adviser to the Rapporteur pointed out that domestic tax systems did treat leases differently from sales. Thus, in a sale the right to the depreciation deduction and other tax attributes related to ownership passed to the buyer. But in the case of a lease, these tax aspects remained with the lessor. While it is often difficult to classify a transaction as between "sale" or a "lease", as a matter of theory, tax systems drew a distinction. This being so, it could be said, from the standpoint of a source country, that taxation of lease payments on tangible personal property could be justified on the basis of history and theory, even though purchases of such property might not be taxable. In this event, the lease rentals are similar to the situation of industrial royalties. The problem thus becomes one of recognition of expenses and determination of the withholding rate applicable to the gross rentals.

54. The Special Adviser to the Rapporteur stated that there was general agreement to support the taxation of rentals from the lease of personal property. Thus, the remaining question was simply whether it was feasible (in the reflection of expenses) to make a precise determination of their amount, or whether some average ad hoc determination should be made.

55. The Special Adviser to the Rapporteur pointed out that a precise determination of taxable income can generally be made under treaties if real property is leased. However, any such determination presumably might be more difficult where personal property is the object of the lease.

56. One member from a developed country felt that the amount of taxable income at source should bear some relation to the profit that the source country would tax if the asset was sold in its territory in a taxable transaction, and that this approach offered some guidance with respect to the reflection of expenses in a lease situation.

II. DIVIDENDS

A. General Discussion

57. The Special Adviser to the Rapporteur noted that the subject of dividends had been discussed by the Group during its first meeting. At that time the views expressed with respect to portfolio dividends had been that such dividends might be taxed at the source and that the country of the investor's residence should give relief by way of foreign tax credit or in some other form. With respect to intercompany dividends, no definite conclusion was arrived at. However, most members felt that there should be some limitation on the withholding tax of the source country, and that relief by way of credit or exemption should be granted by the country in which the parent company was domiciled.

58. The Special Adviser to the Rapporteur referred in this context to the paper entitled "Tax Treatment of Dividends" (ST/SG/AC.8/R.29), in which were discussed the various methods of corporate taxation (the so-called classical method, the split-rate method and the imputation method) and the various approaches to the taxation of intercompany dividends. Another subject for discussion might be whether it would be proper for the source country to tax dividends distributed by a non-resident corporation to non-resident shareholders to the extent that such dividends were derived from profits earned in the source country.

59. A member from a developing country submitted a paper entitled "Some Proposals Concerning Capital Gains and Dividends" (ST/SG/AC.8/IV/CRP.5). He explained that, unlike the rule adopted by the OECD Model Convention, the source country should have the primary right to tax dividends distributed by its corporations. He stated in support of this proposal that the source of the dividends was at the site of the distributing corporation. He also stated that article 10 of the Model Convention had been incorporated only in a very few treaties concluded by developing countries and that most of these countries rejected the principle of the model article that the country of the investor's residence had the primary right to tax dividends. The member also pointed to the fact that most industrialized countries imposed withholding taxes at high rates on dividends paid to non-residents and asked why the developing countries should settle for a low withholding tax. The argument that moderate tax rates were helpful in attracting foreign investment somewhat missed the essential point. While it was true that developing countries were prepared to make certain tax concessions in order to attract foreign capital, the determining factor was the opportunity to realize high profits.

60. Another member from a developing country pointed out that the problem under discussion did not exist in his home country and perhaps in others. The member's home country imposed a corporate tax at the rate of 50 per cent, plus a 33 1/3 per cent tax on dividends paid. The latter tax, which is also on the corporation, is recouped by it upon the distribution of a dividend. The shareholder will gross up the dividend received by the amount of the tax and credit the latter against its own income tax. This system applies equally to all domestic and foreign shareholders regardless of tax treaties. Accordingly, the problem of reducing the statutory withholding tax does not arise. It was also said that any reduction in

the withholding rate for old investments is only a loss of revenue to the developing country and gives no advantage. It is only in the case of new investment that the developing country would grant reduction in the tax rate or exemption as appropriate.

61. A member from another developing country explained that it was necessary to distinguish two different problem areas, namely, (a) the taxation of dividends in the source country, and (b) the question of whether a limitation of the tax should apply when dividends were paid to non-resident shareholders. With respect to the first question, the member explained that the right of the source country to tax dividends distributed by its corporations could not be seriously questioned. Concerning the second question, the member saw no need for a reduction of his country's withholding tax on dividends because its rates were quite modest with respect to dividends paid both to foreign corporations and non-resident aliens. In the case of qualifying foreign corporate shareholders, for example, the local corporate tax was reduced by 65 per cent.

62. A member from a developed country felt that it might be very difficult in view of the great diversity of tax systems to make any categorical statement as to whether the double taxation of corporate profits should be eliminated. The member explained that his country observed strict neutrality of taxation under her split rates of corporation tax concerning the conduct of business by foreign enterprises, whether in unincorporated branch form or incorporated subsidiary form, i.e., that it applied the same over-all amount of tax on corporate dividends and profits of local branches of foreign corporations. A member from a developing country supported this statement by suggesting that article 10 of the OECD Model Convention should be amended to include a new paragraph to the effect that the transfer of branch profits from the source country to the country of the corporation's domicile should be treated as a dividend.

63. A member from a developed country expressed concern that the Group was losing sight of the principles of tax neutrality and proper allocation of revenue between various countries. If tax neutrality is a proper objective, the proper question is not what the rate of the withholding tax on dividends should be, but whether there should be any withholding tax, i.e., whether the desirable result was the complete exemption of intercompany dividends. This question was particularly relevant in relations between developed and developing countries in view of the high corporate tax rates applied in a number of developing countries. With respect to the question of proper allocation of revenue, the prime objective should be to remove tax obstacles to the free movement of capital. A tax on corporate profits in a developing country which was in excess of the corporate rate in the investor's home country would clearly constitute a deterrent to investment, apart from other difficulties of channelling capital to such countries. The member pointed out that most countries eliminate the taxation of domestic intercompany dividends on the grounds that corporate profits should be taxed only once and that the same principle should be applied where parent and subsidiary are situated in different countries.

64. A member from a developing country questioned whether the principle of tax neutrality should be strictly applied as between developed and developing countries. Considering that taxation is a most important instrument of economic policy, the developing countries should be free to tax any income from source in their territory. Stimulation of investment by developed countries could be accomplished by other means. The member further suggested that the investor's home country should give

credit for the full withholding tax of the developing country, even if the rate of that tax had been reduced, so as to secure the benefit of the reduction to the investor rather than transferring it to the industrialized country. The member stated that he recognized the desirability of free movement of capital and recognized that some concessions would have to be made in tax treaties, but such considerations should not be understood to limit the absolute right of the developing countries to tax all income originating in their territory.

65. A member from a developed country observed that if the two groups of countries were interested in reaching common ground, it would be necessary for the developing countries to limit the aggregate amount of their corporate and withholding taxes to a figure that did not exceed the corporate tax rate of the capital-exporting country, if that country applied the foreign tax credit system. The member recognized that there could be no uniformity of treatment under this formula. Depending on the aggregate tax of the developing country on corporate profits, the capital-exporting country might urge a total elimination of the withholding tax of the developing country, a reduction of it or no change at all, depending on the relationship to the rate of the residence country.

66. According to a member from a developing country, the foregoing statement implied that domestic investment would be substituted for foreign investment whenever the tax rate of a developing country was higher than the rate of the investor's home country. In the member's view, this conclusion overlooked that important incentives, tax and non-tax, were offered by practically all developing countries. Accordingly, the flow of capital would not be inhibited by the allegedly high tax rates of the developing countries as long as the investor was assured of an adequate profit. The member from the industrialized country responded that it was not the function of the meeting to consider all the factors that go into investment decisions. The Ad Hoc Group's function was to analyse the tax factors that enter into capital movements and to suggest ways of coping with the existing tax problems.

67. A member from a developing country conceded that both the country of source and the investor's home country had the right to tax the dividend. The relevant question was simply which country was in a better position to make a financial sacrifice. If the developing countries were forced to accept a serious loss of revenue, their economic level obviously could not be raised to that of the developed countries.

68. A member from a developed country applying a foreign tax credit system replied that he was quite sympathetic with these views. The principal problem was to avoid excessive taxation. It was not for his Government, or for that matter for the Government of any developed country, to decide whether or not its corporations should make foreign investments. This was a question which each private industrial corporation must decide for itself. While uniformity of tax treaties between developed and developing countries could not be attained, one of the objects of such treaties, in his view, was to hold the aggregate tax of the two countries to a point where they did not constitute a barrier to foreign investment, so that industrial enterprises in the developed countries could decide on the basis of factors other than taxation whether to invest at home or abroad.

69. An observer expressed himself in favour of the principle of tax neutrality, but felt that it would not be fair to use that principle as an argument to obstruct the progress of developing countries by depriving them of needed revenue. It was necessary to remember that the developed countries should not only promote private

investment in developing countries, but provide the Governments of such countries with needed revenue. Accordingly, there should be no restriction on the right of developing countries to tax dividends from sources in their area.

70. The Special Adviser to the Rapporteur drew a comparison between taxation in the source country of an unincorporated branch and of the subsidiary of a corporation of a developed country. In the normal course the profits of the branch are taxed by the country in which it is located, and the home country of the corporation grants a credit for that tax. While some countries impose a special branch profit tax in addition to the regular corporate income tax, such taxes are exceptional. The situation becomes quite complex, however, when the branch is converted into a local subsidiary. When a branch becomes the subsidiary of a local corporation, there is no problem because domestic intercompany profits are generally taxed only once. If the branch becomes the subsidiary of a foreign corporation, however, there is a tendency to impose a withholding tax because the source country cannot reach the foreign shareholder of the parent corporation. But the question remains whether international intercompany dividends should be treated in a significantly different manner from, and taxed at higher rates than, domestic intercompany dividends.

71. A member from a developed country pointed to the fact that foreign intercompany dividends would not be taxed under the statutory law of his home country even in the absence of a tax treaty. A member from a developing country replied that this was the guiding principle which the developing countries were urging. The member pointed out that developing countries compete with each other to attract foreign investment and that the incentives offered by them go far beyond the area of taxation of dividends.

B. Taxation of dividends

72. A member from a developed country expressed the view that too much emphasis had perhaps been given to the question of taxation in the source country. In the member's opinion this problem should be carefully reviewed in the light of the desired co-operation between industrialized and developing countries. The member felt that the following three areas merited special consideration:

(a) Many corporations would prefer to operate in a foreign country through a branch rather than a local subsidiary, but were compelled for a variety of reasons to select the latter form of organization. Given this situation, fairness and tax neutrality required that the tax treatment of branches and subsidiaries be equalized. One consequence of this view was that the withholding tax on dividends distributed by such subsidiaries would be abolished;

(b) Each industrial corporation was faced with a decision whether to invest at home or abroad. Accordingly, the countries in which investments were contemplated must be prepared to offer inducements to such investments. They should, in particular, recognize that an investment at the corporation's domicile was taxed only once, and that excessive taxation in the foreign country would act as a barrier to investment, apart from violating the principle of tax neutrality;

(c) Withholding tax on dividends should be considered in the context of taxation at the domicile of the investing corporation. The country of domicile should grant an exemption for dividends so that the tax level would be determined solely by the country in which the investment was made. Conversely, that country

should give recognition to the benefit extended by the country of residence by cancelling its withholding tax on dividends or reducing it to a low rate, at least where the investment was substantial in terms of the percentage of share capital of the foreign subsidiary.

73. A member from a developing country observed that new issues concerning the developing countries were being introduced into the debate. The statement that a locally incorporated subsidiary bore a greater tax burden than an unincorporated branch was not true in all cases. In the member's home country, for example, incorporation would result in a considerable reduction of tax because that country imposed a much heavier tax on non-residents than it did on resident companies. The member further noted that withholding tax became effective at the final point when the dividend reached the shareholder. This, however, was not true in relation between resident and non-resident companies because the shareholders of the non-resident company were outside the reach of the source country. The member agreed that if the investor's home country was prepared to give relief, the developing country should reciprocate by waiving or reducing its withholding tax on dividends.

74. A member from another developing country emphasized that the source country had the primary right to tax income derived in its area, including dividends distributed by a local subsidiary. The principle of primary right of the country of source was recognized by the OECD model commentary on articles 23 (a) and 23 (b), providing that the state of residence must give relief where the taxation was assigned to the source country. The member felt that there was no necessity for a developing country to waive or reduce its withholding tax on dividends, considering in particular that those countries offered tax incentives and other concessions.

75. A member from a developing country observed that it was important for a foreign investor to know that he would not be subject to a higher tax in the developing country than he would pay in his own country. This point, and not the matter of incentives, should be the primary consideration. It should also be considered that the security of the investment and the investment climate were at least as important as the expected rate of profit. The member finally observed that under the tax system of his country only a partial tax was paid on distributed profits as distinguished from retained earnings, and that there seemed to be no need in such a situation to reduce the withholding tax on dividends.

76. Several observers agreed with a member from a developed country that the Ad Hoc Group should look into the relative tax position of local branches and subsidiaries. The member also submitted that as a matter of experience, the greater part of dividends received by a parent company in the developed country was reinvested rather than redistributed to its own shareholders. Accordingly, it would be necessary to consider the total tax burden on the reinvested profits rather than look only at the tax paid by the ultimate shareholder.

77. The Special Adviser to the Rapporteur read the following summary of the tax discussion held during the third meeting of the Ad Hoc Group.

78. With respect to the subject of intercorporate dividends paid by a subsidiary company in one country (source country) to a parent company in another country (residence country), there was general agreement that, considered as a jurisdictional matter, the country of source would be in a position to assert a tax on the profits

of the subsidiary and also on the dividends paid by it (usually as a withholding tax), while the residence country would be in a position to assert a tax on the dividends received by the parent, subject to any unilateral double taxation relief it might grant. It was recognized that some source countries might claim an exclusive right to tax the dividends, though realizing that residence countries would nevertheless assert their claim to taxation. On the other hand, some residence countries, might forgo a tax on the dividends on the theory that intercorporate dividends should not be taxable whether they occur internally within a single country or externally between two countries. Further, it was evident that the customary withholding rates applied at source on dividends tended to be at significant levels, so that when coupled with the basic corporate tax rates the total effective tax rate in the source country on the dividends would be quite high. Such high effective rates coupled with full taxation of the dividends in the residence country would imposed a severe, often insurmountable barrier to the international flow of investment capital. This was the background against which measures to relieve double taxation and tax treaties were to be considered.

79. Turning to such measures and tax treaties, it was recognized that the general practice of many residence countries was to grant a credit for the tax paid in the source country on the profits of the enterprise, as realized by the subsidiary company, thereby in effect recognizing the primary assertion of jurisdiction over such profits by the source country. This recognition was essentially the same as occurred when the activity was conducted in a branch form in the source country, and a credit was given for the tax on branch profits. In the dividend case, as in the branch situation, the residence country in taxing the dividend would pick up any difference in tax rates when the basic corporate tax (including any withholding tax on dividends and profits and branch profits) in the source country was at a lower level, thereby making certain that the profits paid a total tax equivalent to that in the residence country and thus achieving tax neutrality with domestic investment in the residence country. Other residence countries which did not use the credit approach often recognized the source jurisdiction through exemption of the dividend.

80. If the activity were operated in branch form, this tax at source and credit or exemption in the residence country would typically be the end of the matter (except for a few countries which levied a tax on distributed branch profits). The question then arose, if the activity was operated in corporate form in the source country, whether any further tax consequence should result. It was to be noted that in many situations operation in subsidiary form in international operations was appropriate or even required, as where local minority interests were involved. It was recognized that generally, under most tax systems, operations in parent-subsidary form entirely within a country did not create a higher tax burden than operation through a single corporation, since intercompany dividends were relieved of corporate tax. This approach in domestic tax systems was based on an awareness that applying substantial taxes as corporate profits moved along a domestic corporate chain could well impose too severe a tax burden on the enterprise.

81. It was recognized that this same approach had application to international corporate enterprises. So applied, this approach would mean a limitation of withholding tax on dividends paid by the subsidiary in the source country. While such withholding taxes were in one view applied because the ultimate shareholders of the enterprise were outside the source country, nevertheless the profits were still being held at the corporate level and indeed might never be distributed to the ultimate shareholders, or at least not until much later in the future.

82. However, the developing countries, while appreciating this approach, were generally desirous of limiting their withholding taxes only if the limitation benefited the international investor, since the basic purpose of the limitation would be to remove barriers to the movement of capital. In this light, several approaches were recommended which received general acceptance as useful guiding principles in the bilateral negotiation of tax treaties between developed and developing countries.

83. First, if the developed residence country used a credit system the negotiations could appropriately seek a limitation on withholding tax rates at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate that did not exceed the tax in the residence country. In ascertaining the effective rate that existed in the absence of limitation, consideration would be given to the effect of tax incentives and other provisions in the source country affecting the rates of tax. Hence a treaty could produce different withholding rates at different stages of activity of an enterprise as incentive measures ceased to be operative. It was further recognized that distinctions could be drawn in the negotiations, if appropriate and feasible, between old and new investments. This over-all approach could, it was understood, result in varying reductions from its withholding rates for the same source country in various treaties, depending on the relationship between its combined effective rate and the rate of the different residence countries. Or to put it another way, the treaties of a residence country could contain varying reductions in withholding rates among the developing countries with which it had treaties. Any limitation in withholding rate so negotiated would of necessity be a benefit to the investor, since the purpose of the limitation would be to reduce the effective rate in the source country to the credit level of the residence country.

84. Secondly, if the developed country used an exemption system for double taxation relief, in a bilateral negotiation it might seek a limitation on withholding rates on several grounds: (a) that the exemption itself stressed the concept of not taxing intercorporate dividends, and a limitation on the withholding rate at source would be in keeping with that concept; (b) that the exemption and consequent departure from tax neutrality with domestic investment were of benefit to the international investor, and hence a limitation of the withholding rate at source would be in keeping with this step, since that limitation would also benefit the investor.

85. The above two basic approaches, applicable in negotiations with credit or exemption residence countries, offered useful guiding principles to the level of withholding rates of developing countries to be fixed in bilateral negotiations. They did not fix specific rate limitations of withholding tax on dividends, nor did they negate the jurisdictional claims of source countries. Rather they allowed the two treaty members to work out through negotiation the appropriate level of withholding rate on dividends in the developing countries that was conducive in the particular situation, considering the basic corporate taxes in the two countries and the character of double taxation relief offered by the residence country, to the movement of investment capital desired by those countries.

86. The level of treaty withholding rates in a developed country, when it was the country of source, appeared to involve various considerations. Those rates could remain unchanged from their unilateral levels where the developing country was not interested in seeking a reduction, thereby providing a different set of rates for

the two countries in a particular treaty. Or they could be reduced along lines parallel to those set in the treaty for the developing country, if that was the desired approach.

C. Portfolio dividends

87. The discussion on the subject of dividends paid on portfolio investments was opened by a member from a developed country. The member submitted that if the Group wished to be consistent with the position that was generally adopted with respect to intercompany dividends - namely, that the total of the corporate and withholding taxes of the developing country should not exceed the corporate tax in the investor's home country - it should recognize the same principle with respect to portfolio dividends. Considering that there was at this time only limited portfolio investment in developing countries, the member posed the question of how an investment company ("mutual fund") or "unit trust" would fare if it should decide to make investments in developing countries. Since the net income of such funds was normally passed on to the shareholders, the latter should not pay a disproportionately high tax on dividends from sources in developing countries as compared to the tax on domestic investments of the fund or the shareholder's income from other sources.

88. Accordingly, tax treaties between industrialized countries and developing countries should provide for a moderate withholding tax on portfolio dividends. Apart from the situation of the individual investor, the investor's home country had a legitimate interest in collecting some tax on this income, considering that large amounts of capital were invested abroad. While uniformity could obviously not be attained, the investor's home country, if it applied the foreign tax credit, could not be satisfied with collecting little or no tax on the foreign income if its own tax rate was lower than that of the countries in which the investments were made by the fund.

89. Another member from a developing country stated that there was little or no foreign portfolio investment in his home country at this time. If such investment should develop, however, it would not be treated unfairly under the tax system of his country. This tax system provided for a preliminary withholding tax at the rate of 33 1/3 per cent. The investor was free to file a return and obtain a partial refund of tax if the assessed rate was less than the withholding rate. In any case, only income from sources in the member's country, and not the world-wide income of the investor, would be considered. With respect to the foregoing, some members remarked that the filing of a return and refund claim in a foreign country would be considered a heavy burden by some investors.

90. A member from a developed country stated that the collection of revenue had various objectives such as, among others, equalization of income, financing of public services or the channelling of investment in certain directions.

91. He pointed out that if the investment was made in the investor's home country, the fruits of this investment remained in that country, partly as a return to the investor and partly as a tax to the Government. If the investment was made abroad, the income therefrom might or might not be repatriated, and if it was repatriated, it would be reduced by the foreign tax. If the tax rates of the investor's home country and of the country in which the investment was made were the same, the maximum return to the home country would be the income reduced by the foreign tax. Developed countries with unemployment and balance-of-payments problems,

demands for increased social expenditures and the like might not be inclined to encourage foreign investment. If members accepted the principle that the investor's home country was entitled to a tax on income from foreign investment, there was no merit to the contention that the taxes imposed in a developing country on residents and on non-residents must necessarily be identical. On the other hand, the member suggested that the source country might in some circumstances be justified to impose a higher tax on portfolio investments than on direct investments, leaving it to the investor's home country to apply whatever relief it considered appropriate.

92. An observer from a developing country stated that portfolio dividends should be taxed at a higher rate because direct investments bring many benefits (such as know-how) and bear larger risks than the portfolio investor.

93. One member from a developing country pointed out that the tax system of his country made no distinction between portfolio and direct investments. Accordingly, there was no problem if the investor's home country imposed tax at a higher rate than did the member's home country. The problem would arise if the home country's tax was the lower one. While it was true that the home country, assuming that it applied the foreign tax credit, would not collect any tax in this situation, this result was not necessarily unacceptable, because the investment also constituted a contribution by the industrialized country to the economy of the developing country.

94. Another member from a developing country felt that portfolio investment was essentially different from direct investment. An individual shareholder of a large domestic or foreign corporation would usually be ignorant and unconcerned about the company's tax situation. Since portfolio investors in foreign countries were usually not poor people, but more likely in a high tax bracket, elimination or substantial reduction of the withholding tax on dividends distributed to such investors would not seem to be justified. Apart from this, the aspect of non-discrimination between domestic and foreign investors should also be considered.

95. The Special Adviser to the Rapporteur summarized the preceding discussion of the Ad Hoc Group on the treatment of portfolio dividends. He stated that the subject matter apparently had not aroused as much interest as the subject of dividends from direct investments. Even so, the question had to be dealt with because the level of withholding rates on portfolio dividends was a proper subject of treaty negotiations. In some respects, portfolio dividends presented fewer problems than did other items of income because it was not necessary to consider expenses and certain other complicating factors. Some members felt that there could be some guidelines in the negotiations, such as whether withholding rates on portfolio dividends should be the same as those on intercompany dividends, and whether the differentiation between new and old investments could be made with respect to portfolio dividends.

96. The Special Adviser to the Rapporteur suggested that the Ad Hoc Group might now discuss the factors which distinguished portfolio investment from direct investment.

97. A member from a developed country recommended that the Ad Hoc Group agree on a definition of the term "direct investment" before attempting to distinguish the two types of investment. The member suggested that the percentage of the share capital of the foreign subsidiary owned was not the only factor to be considered,

but that it was also necessary to give attention to the nature of the investor. The member observed that at this time, an individual would not be recognized as a direct investor under the laws of most countries, even if he owned the entire share capital of the foreign corporation. In the member's opinion there was no valid reason for limiting the application of the term to corporations.

98. A member from a developed country pointed out that an intercompany shareholding of at least 25 per cent was recognized as a direct foreign investment by the OECD Model Convention. In the opinion of a member from a developing country, this rule might have to be modified in the case of certain developing countries which, like his own country, put limitations on the percentage of share capital of local corporations that foreigners were permitted to acquire. The member mentioned that his country limited such investments to 50 per cent of the share capital, but did not distinguish between individual and corporate investors. The OECD Model Convention, on the other hand, envisaged no limitations on the percentage of capital that could be acquired by foreign investors. Accordingly, one half of the 25 per cent rate, or 12 1/2 per cent (perhaps to be reduced to 10 per cent), should be accepted as the minimum direct investment in the member's home country and other countries imposing similar limitations on foreign direct investment.

99. Another member from a developed country stated that if the neutrality between branch form or a subsidiary form of foreign investment was in question, this percentage should not be as low as 10 per cent.

100. With respect to "portfolio investment", there was general agreement that, as elsewhere, both the source and residence countries as a jurisdictional matter were in a position to assert a tax on dividends paid on the shares involved. Members from developing countries indicated that the relatively small amount of portfolio investment and its distinctly lesser importance compared with direct investment made the issues concerning its tax treatment less intense. Nevertheless, guidelines were appropriate for tax treaties on this subject. There was general agreement that the accommodation of the claims of the residence and source countries was a proper matter for negotiation, which would seek a sharing of the revenue appropriate to the particular situation. Such sharing could involve a reduction in the source country withholding rate and credit in the residence country. As further guidance, some members from developed and developing countries were favourable to a treaty approach that would provide similar treatment for withholding rates on both direct and portfolio investment, recognizing here also the matter of differentiating old and new investments; other members preferred a higher rate on portfolio investment. Another member would use the initial standard of a withholding tax not higher than the net burden on domestic shareholders and then in negotiations consider any further charges. On the whole, however, most members did not perceive any further principles for guidance in the negotiations and were content with the generalization that the appropriate sharing was a subject for negotiation.

101. As to the dividing line between portfolio and direct investments, there was general agreement that a 10 per cent share ownership, whether held by a corporation or an individual, would constitute a direct investment, though some members would not extend such 10 per cent ownership figure to individuals. The setting of this percentage figure took account of the fact that in some developing countries non-residents were limited to a 50 per cent share ownership, so that the 10 per cent level represented a significant portion of such permitted ownership.

III. EXCHANGE OF INFORMATION AND INTERNATIONAL TAX EVASION AND AVOIDANCE

A. General discussion

102. A member from a developing country opened the discussion by stating that the subject matter was of the utmost importance to developing countries. All government aid and encouragement of private investment by developed countries could be rendered ineffective if there was widespread tax evasion and avoidance in the developing country. The member referred in this context to the report of the Royal Commission concerning the Canadian tax reform and to documents submitted to the Group for discussion at the present meeting (ST/SG/AC.8/R.38 and ST/SG/AC.8/R.41). The member pointed out that bilateral as well as multilateral co-operation between nations was called for to combat international tax evasion because such co-operation was necessary for the benefit of the world economy as a whole. It was well known that tax evasion was often connected with serious anti-social activities. The member referred to the replies of various members to the United Nations questionnaire on exchange of information concerning the types of information required and the agencies suitable to provide such information.

103. The member referred to some common forms of tax evasion, such as the case where goods exported from a developing country were under-invoiced or goods imported into such a country were over-invoiced. In either case the difference between the price actually agreed upon and the invoice price was deposited abroad for the benefit of the local party. In the case of over-priced goods, the importer realized an additional unjustified benefit by claiming excessive depreciation charges on the property. These examples showed that there must always be collusion between the local party and a foreign party to perpetrate tax evasion, thus demonstrating the need for full co-operation between the two countries affected. In order to assure such co-operation the rules on exchanges of fiscal information should be made mandatory so that the submission of pertinent data was not left to the discretion of one or the other country.

104. A member from a developing country reported that there had been widespread tax evasion in his country, amounting to no less than 10 per cent of all revenue to be collected. The Government had at one time undertaken an energetic drive against tax fraud, followed by a general amnesty. The latter had had the effect that unexpectedly large amounts of previously unreported income were disclosed and subjected to tax. However, it had not put an end to tax evasion.

105. The member noted that, as between developed and developing countries, the latter were always the victims of tax evasion; full co-operation by the tax authorities in the developed countries was required to stop such unlawful practices, and information was needed for that purpose. This matter had already been discussed in previous meetings of the Ad Hoc Group. 6/ The member remarked that effective control of tax evasion as well as violations of currency control regulations required detailed cross-checking of tax returns and other data in the countries concerned. Apart from the loss of revenue, the demoralizing effect

6/ Tax Treaties between Developed and Developing Countries (United Nations publication, Sales No. E.69.XVI.2), p. 10 and Tax Treaties between Developed and Developing Countries (United Nations publication, Sales No. E.72.XVI.4), pp. 24-26.

of tax evasion practices on less affluent taxpayers should be considered. The member emphasized that very little punitive action could be taken against tax evaders unless the injured Government was in a position to submit adequate evidence. For this reason the fullest co-operation on the part of industrialized countries was required, in a case where the developing country made a specific request for information. Very often, sufficient evidence was available in the developed country so that the Government of that country should not find it difficult to comply with the request of the developing country.

106. The member read from a published study on tax evasion in his country, excerpts of which are attached hereto.

107. A member from a developed country referred to article 26 of the OECD Model Convention which provides excellent guidelines for the exchange of fiscal information between treaty countries. This article had been discussed at some length during the First Meeting of the Group. 7/ The member could see no reason why the substance of this article should not be incorporated in treaties between developed and developing countries and asked whether more was needed.

108. A member from a developing country agreed that the principles included in the model article were of great importance. However, he felt that the range of that provision should be considerably expanded so as to also include matters not covered by the convention. The member suggested that the Group should decide on methods of co-operation in the matter of international tax evasion, which was a threat to all countries and could not be handled satisfactorily by any one country alone.

109. A member from a developed country noted that excessive tax rates, the disallowance of normal and necessary expenses under the law, or practices of some countries gave rise to tax evasion in some instances. The member mentioned the case of a business executive assigned to a country which either disallowed the deduction of certain normal expenses or put a heavy tax on the fringe benefits usually granted to expatriate employees, such as allowances for housing, education of children, home leave and so forth. Unless the employer absorbed the additional tax, the employee might be tempted to report only a portion of his income. The member felt that if a country gave fiscal information to countries which denied the deduction of normal and necessary expenses, then the deductions should be granted.

110. A member from another developed country pointed out that the powers available to the tax authorities varied considerably from one country to another. A prime example was the secrecy of bank accounts which was abrogated vis-à-vis the fiscal authorities in several major countries, including France and the United States of America, but was observed in other countries. In general, the information available to the fiscal authorities varied enormously, even among different developed countries. Some of these countries prescribed that payments of certain income such as interest and dividends be reported to the tax authorities, while other countries had no such requirements. Similarly, there were wide differences between the investigative powers of various Governments. The member suggested that the Group should first agree on a minimum level of information to be exchanged before proceeding to points of detail.

7/ Tax Treaties between Developed and Developing Countries (United Nations publication, Sales No. E.69.XVI.2), p. 18.

111. An observer from a developing country suggested that the Group should agree on the most common forms of tax evasion and attempt to find solutions for their prevention. To illustrate the necessity for disallowing otherwise normal expenses, the member explained that his country had felt constrained to prohibit the deduction, by local companies, of royalties and technical assistance fees paid to foreign parent companies because the deduction had been grossly abused. The member remarked that it might be possible for his country to reinstate this deduction if the developed countries would first provide the fiscal information required to curb tax evasion in his country.

B. Evaluation of the problem

112. The Ad Hoc Group continued its discussion of exchange of fiscal information.

113. The discussion was opened by a member from a developing country, who evaluated the respective merits of routine exchanges of information and information given upon specific request of another country.

114. The member felt that while routine exchanges of information were useful, they constituted a burden on the country assuming this obligation, considering that only part of it was likely to be utilized. The usefulness of this information to the country receiving it also depended to some extent on the scope of the latter's investigative facilities. Where a developing country had wide powers of this kind, routine information supplied by other countries was perhaps less needed than in other cases. The member stated that a country could strike a reasonable balance by collecting fiscal information on a selective basis, e.g., information regarding the reporting of interest in one year and dividends in another year, so as to make full use of the information received and avoid excessive burdens on the other countries.

115. The member emphasized that information supplied in response to a specific request was of greater importance. There was also a question at what stage of the investigation the request should be made, i.e. at an early stage, when fraud was suspected but not as yet proved, or at a later stage, when this information was needed only to complete the evidence. Apart from cases involving specific taxpayers, there were also situations where certain fraudulent practices were suspected by the administrative agencies. Requests for information concerning such groups of cases might also be addressed to other Governments.

116. The member then discussed the procedures through which the required information could be obtained. Bilateral as well as multilateral agreements might serve this purpose. The member referred in this context to document ST/SG/AC.8/R.41, which discussed certain weaknesses of bilateral agreements in this respect. The member also discussed the possibility that two countries might agree to co-operate in the area of tax evasion, even if they could not agree on a general tax convention. Such a partial convention would cover the areas of tax avoidance and evasion and exchange of fiscal information. The member suggested that the Ad Hoc Group should make a recommendation concerning such an alternative.

117. A member from a developed country mentioned that his country and a group of other nations in the same geographical area (Scandinavia) had entered into bilateral agreements concerning fiscal co-operation as early as the 1940s. These agreements, which now were somewhat outdated, had been replaced by a multilateral

convention that had been signed the previous month and would take effect at the beginning of 1973. The new convention covered all taxes and charges aside from income taxes, such as taxes on net worth and inheritances, social security contributions and other levies.

118. A representative from another developed country stated that his country reported payment of dividends, interest and royalties as a routine matter to its treaty partners in which the recipient of these items of income was resident, and that one of the difficulties encountered in connexion with exchange of information was safeguarding the secrecy of such information. The member then commented on the statements in document ST/SG/AC.8/R.41, especially with regard to the reconciliation of the powers given under domestic legislation and those given by tax treaties; the obligation of the developing countries to explore their own ways and means of investigation before requesting information and assistance from abroad; elimination of a tax haven and international co-operation both to combat multiple international tax evasions; limits to requests for information; and collection of information in the requested country by officials of the requesting country themselves.

119. A member from a developing country mentioned that his country had been mentioned as the only one which did not support the requests for routine exchange in its reply to the United Nations questionnaire on exchange of information. The point was that the items which should be covered under the general heading of "routine information" had not been clearly spelled out. There also was no explanation regarding the administrative level at which the decision to submit information to another Government should be taken. The member explained that his country, like other developing countries, suffered from a shortage of manpower and administrative facilities and could ill afford to divert administrative personnel from their regular duties to supply information to foreign Governments. On these grounds the Government of his country had decided to limit itself to answering specific requests for information. The member added that extension of the withholding of tax at the source on certain types of income was under consideration in his country because this technique had proved very useful both to prevent evasion of tax and to provide fiscal information. The member suggested that countries should also exchange information on their systems of tax administration and specific methods of combating tax evasion, so that other countries could study this information and improve their own systems.

120. A member from another developing country felt that even more important than exchange of fiscal information was an international exchange of information concerning movements of exports and imports. The member recommended that the Group consider the creation of a multinational convention under which some central agency for the investigation of international tax fraud cases might be installed.

121. A member from a developed country felt that it was not practicable to have a multilateral instrument, and bilateral agreements represented a better approach. He expressed the opinion that exchange of fiscal information was a very difficult matter, apart from detailed questions such as whether information should be made available to other Governments as a matter of routine or only upon specific request. The basic fact was that the tax systems of the various countries are autonomous and shaped in a very different manner. These differences obviously have an effect on the exchange of information between Governments. A country might hesitate to provide fiscal information to another country whose tax system it considered discriminatory or confiscatory, or lacking adequate investigative

facilities of its own. The member asserted that exchange of fiscal information was certainly a desirable procedure which should be followed and approved and worked out step by step. This procedure was also sanctioned by article 26 of the OECD Model Convention and followed in practically all bilateral tax treaties. There was no reason why an article providing for exchange of fiscal information should not be included in a treaty even if it was only a partial treaty that did not include all the customary substantive provisions. Beyond this, a step-by-step approach was desirable.

122. A member from a developing country agreed that a step-by-step approach might be the preferable procedure under the circumstances. Members had already agreed on the desirability of including exchange of information provisions in bilateral tax treaties. The next question would be the scope of such treaty articles. Some developing countries might consider the collection of fiscal information for the benefit of other countries a heavy burden and, on their own part, might not be able to absorb all the information supplied to them by other countries. As already suggested, it might be possible to find a compromise solution under which information would be supplied on a continuous basis, but only on certain phases of taxation. In any case, the countries requesting such assistance should first exhaust their own investigative facilities.

123. A member from a developed country agreed that the transmission of routine information was at present only of a limited usefulness. In most cases, such information covered income from capital (dividends, interest and royalties). Information of this kind was almost useless because it would become available only if the recipient of the income in the other treaty country applied for a refund of withholding tax, which only an honest taxpayer would do. A taxpayer intent on concealing this income would not take any steps to recover the withholding tax. The member stated that his country represented perhaps an exception in that it required all payers of fixed or determinable income to file certain information with the Government. This information was sent once a year to the treaty countries in which the recipients of the incomes were resident. Such a system would obviously be a very useful source of information if it were adopted by other countries.

124. The member suggested that a meeting of high-ranking fiscal policy officials might perhaps be convened to agree on internationally acceptable rules. The gathering and exchange of fiscal information might be one of the topics to be discussed by such a body.

125. With respect to the supply of information upon specific request of another country, the member observed that not only questions of fiscal fraud, but other matters such as the pricing of goods, services, royalties and disclosures of bank accounts and the like were a proper subject for investigation. With respect to improper pricing, there were useful published data that could be employed to advantage. Some international organization could undertake regular publication of current prices of heavy machinery, agricultural products and other major items of international trade, which could be usefully circulated to tax administrations for their information. A specific problem in the member's view was that Governments, as a rule, were not inclined to report on their own nationals to the Government of another country, particularly when there was a feeling that the latter's efforts were sporadic and discriminatory.

126. The member then commented on the situation of nationals of one country who were being transferred to another country for a limited time. Apart from the effect of

excessive taxation in the source country, which had been discussed earlier, there were countries which required such visitors to declare the total assets which they had accumulated prior to their arrival in the country to which they were assigned. Business visitors were naturally reluctant to give such information, fearing confiscation or blockage of their property, or an abuse of the information given to the host country. Accordingly, they sometimes resorted to devices to avoid giving such information, thus violating the laws of the host country. The member added that his country would hesitate to enforce the reporting of such information to a host country of this kind if it had a treaty with that country.

127. Regarding mutual assistance by treaty countries in the matter of tax collection, the member observed that such provisions might be useful and workable as between countries with similar legal rules and procedures, although even in such cases the courts of one country often refused to enforce the collection of taxes of another country. Where the two countries had very different traditions concerning equity and due process, broad mutual collection provisions were difficult to enforce.

128. Another member from a developing country declared that he agreed with the need for exchange of information provisions, but felt that a number of qualifications would have to be added. Whatever the theoretical merits of provisions regarding routine exchanges of information might be, the fact was that such provisions did not work in practice. Perhaps such procedures might be workable with respect to narrowly defined situations, such as the case of border crossers (individuals who lived in one country and worked in the neighbouring country).

129. A member from a developing country observed that there seemed to be full agreement among members on the desirability of exchanging fiscal information. The member felt, however, that the qualifying clauses (paras. 2a and 2b) of article 26 of the Model Convention were too restrictive and should be removed in tax treaties between developed and developing countries. In the member's opinion, this was a question which should be decided on the policy-making level, rather than by the Ad Hoc Group of Experts who were essentially tax technicians. The member also agreed that a country should fully exhaust its own administrative remedies before turning to other countries for administrative assistance.

130. A member from a developed country felt that there were a number of problems which could not be simply solved by inserting a provision in a tax treaty. He was glad to see that some earlier ambitious proposals were scaled down gradually to more realistic suggestions. To this member's view one realistic approach would be to recognize that the conclusion of comprehensive tax agreements naturally leads to an extensive exchange of information, so that any treaty provision in this respect appears to be superfluous. The member recalled that his country made an express reservation to article 26 of the OECD Draft Convention, and he stated that as express a reservation would be made to any such clause which this Group would recommend for adoption. The member also drew attention to the difficulties (referred to in document ST/SG/AC.8/R.41, pp. 30-32) encountered in the implementation of a provision of a single tax treaty, on the basis of which the requested country was asked to convert the exchanged information into a form which would satisfy the complex judiciary procedures of the requesting country.

131. The Special Adviser to the Rapporteur felt that it was true that the matter had technical as well as policy aspects. The question of whether article 26 of the OECD Model Convention was or was not adequate was in his opinion a technical

problem which could be resolved by the Group. The relevant questions to be settled were the types of technique to be applied to counter tax evasion and the nature of information to be transmitted. Another question suitable to be settled by the Group was the manner in which industrialized countries could assist the developing countries in this area.

132. The Special Adviser to the Rapporteur felt that many of the difficulties of providing necessary information that had been mentioned would not be insurmountable and could be resolved by the competent authorities of the two countries. Even if there were wide differences between the tax systems and administrative practices of the countries, the fact that they were able to conclude a tax convention proved that there could be a basis for agreement on exchange of information and solving real difficulties, as had been described. There were, of course, considerable differences concerning the degree of technical expertise and available technical facilities between the various countries. Some of these differences might be manageable and some might not. This question also would be a proper subject for bilateral negotiations. Problems of differing authority in various countries to obtain tax information, e.g. the effects of bank secrecy and bearer shares, which could lead to adverse competitive problems for taxpayers in countries able to secure the information if it were exchanged in situations where it could not be secured or exchanged from other countries might require a multilateral solution.

133. The Group continued the discussion of exchange of information. A member from a developing country pointed out that while the need for the exchange of fiscal information between Governments was generally recognized in tax treaties, the question of how to implement this principle was apt to present difficulties. There seemed to be agreement that automatic exchanges of information were not as useful as desired because much information transmitted under this method was not always helpful. Concerning the investigation of specific cases, the assistance of the developed countries was needed because of their more sophisticated administration facilities. The member recommended that the Group support his proposal for a world-wide exchange of fiscal information because tax evasion resulted in very great economic detriment to the developing countries. There might be less need for foreign aid if the loss of taxes and foreign exchange that resulted from the manipulations of tax evaders could effectively be curtailed.

134. A member from another developing country supported this view. The member explained that the tax administration of his country had concentrated its investigative activities on the 10 per cent of taxpayers - mainly large industrial and commercial firms, importers and exporters - who accounted for 80 per cent of the total revenue. This practice had helped greatly in reducing the loss of revenue, which had been enormous in former years. However, exchange of fiscal information with other countries was indispensable, especially in order to complete the evidence which under the procedural rules of his country was required to obtain the conviction of tax evaders in a court of law.

135. The member further expressed himself in favour of bilateral agreements providing for exchange of fiscal information even if such treaties were incomplete. He also advocated strengthening the treaty articles so as to make the exchange of fiscal information mandatory. He felt that it would be wrong to limit the information to fraud cases and that information useful to implement the statutory provisions of the contracting countries should also be included.

136. While agreeing that a country should not be held responsible for enforcing the tax laws of another country for the collection of taxes, the member also urged that other countries should nevertheless help with tax collections the country which was deprived of its revenue because taxes were not paid and the funds needed to pay them had been removed from the country.

137. A member from another developing country pointed out that tax treaties were concluded for the prevention of double taxation as well as to encourage the international flow of investment and for the prevention of tax avoidance. The member stated that while article 26 of the Model Convention was quite acceptable in principle, the second paragraph of this article imposed many restrictions. There should be a multilateral convention under which the domestic law of the various countries would be set aside as far as necessary to combat tax evasion. While every country should protect its citizens and therefore not disseminate fiscal information indiscriminately, the Group should not lose sight of the fact that tax evaders are criminals and that Governments should co-operate in this area as they do through INTERPOL in combating non-fiscal crimes. The member suggested that the Group make a formal recommendation concerning the world-wide approach.

138. A member from a developed country pointed out that there was no disagreement concerning the need for co-operation between Governments in the matter of fiscal evasion. However, the need for some restraint in this area should also be recognized. It would be desirable to delineate the conditions under which the rules concerning exchanges of fiscal information should be permitted to operate. Many developing countries had not as yet created the environment in which adequate compliance by taxpayers could be expected, in particular by holding tax rates to a moderate level and maintaining a high degree of enforcement. The member referred in this context again to the case of an individual employee assigned to a foreign country whose tax burden was drastically different from that in his domicile. In cases of this kind the country of domicile would probably be most reluctant to give information to the requesting country other than data concerning the compensation for the services rendered in that country. Limitation of exchanges to the nationals of the requesting country would make an exchange of information much more acceptable and might be included in tax treaties. The member referred in this context to the tax system of another developed country which recognized different grades of residence, treating an individual whose residence was of short duration considerably more leniently than one with a permanent domicile in the country.

139. The member added that in the case of corporations, the relevant question was usually that of proper allocation of income rather than of fiscal fraud. Here again a country with a highly developed enforcement system might be reluctant to give information to another country where the level of taxpayer compliance is low, especially if corporations of the first-named country were clearly the principal target of the tax administrators of the country requesting the information. The member suggested that certain limitations be included in the text of a treaty article dealing with exchange of fiscal information so as to prevent residents or corporations from one treaty country from being victimized by the tax authorities of the other country.

140. The Special Adviser to the Rapporteur pointed out that the subject just discussed could be divided into two areas, namely (a) the question of what the burden of taxation on temporary residents of a treaty country should be; and

(b) the characteristics of the tax administration in the source country and the conditions surrounding the enforcement of taxes by that country. In the opinion of the Special Adviser to the Rapporteur, the latter aspects would more properly be covered in a protocol or memorandum of understanding accompanying the convention than in the body of the convention itself.

141. A member from a developed country felt that it would not be necessary to expand the coverage of the traditional exchange of information article and that no disclosures should be requested which would conflict with the laws of the reporting country. The existing difficulties resulted for the most part from shortcomings of the various tax administrations, especially lack of manpower, rather than the text of the treaty articles.

142. With respect to the proper pricing of goods, a member from a developed country suggested that some international organization undertake the publication of prices of capital goods that are frequently sold, so as to provide government auditors with the information needed by them.

143. Members then discussed the desirability of close co-operation between the income tax department, customs department and exchange-control department of a given country, and described the various degrees of co-operation between these agencies in their home countries. One observer reported that joint efforts by his organization and the Customs Co-operation Council in Brussels had disclosed considerable differences among the prices of imported and exported merchandise, especially those of proprietary goods.

144. The Special Adviser to the Rapporteur stated that it was the sense of the meeting that references to tax fraud and fiscal evasion should be specifically included in the treaty article dealing with exchange of information. Another matter to be dealt with was that of the employee temporarily resident, which perhaps could be covered in the services article. As to the discriminatory treatment of corporations of the other country, to which reference has been made before and which might act as a disincentive to a country to supply information to the other treaty country, that should be considered in bilateral negotiations.

145. The Special Adviser to the Rapporteur further stated that the Group had considered whether the national law of a country entering into a tax treaty should yield to treaty rules in the matter of the exchange of fiscal information. Most experts did not seem ready to adopt such a rule. This problem area might be discussed at a future meeting and then perhaps have to be referred to the policy-making bodies of the various countries.

146. Another principal question of prime importance was that of transmitting information concerning under- and over-invoicing. Thus far members from developed countries had not expressed their views on the ability to supply information to developing countries on the extent to which such information was available in the developed countries.

147. A member from a developing country stated that while the question of invoicing was of the greatest importance to developing countries, not much help could be expected in his experience from the Customs Co-operation Council. This organization had developed certain theoretical valuations which might quickly become outdated.

148. A member from a developed country pointed out that article 26 of the OECD Model Convention referred to fiscal information, implying that such information should not be disclosed to the customs authorities and exchange control authorities of the treaty countries. As in many countries these authorities were working closely together, this approach seemed to be unrealistic.

C. Draft model article

149. The Ad Hoc Group then discussed the draft of a model article covering the exchange of fiscal information which had been submitted by a member from a developing country. One member expressed the view that some limitation should be formulated. He recommended inclusion of a provision that the contracting countries should define the methods and techniques as well as the conditions under which, and the matters in which, such information would be exchanged. Several members from developed countries expressed themselves in favour of the draft article as amended in that way.

150. The Ad Hoc Group then discussed the terminology to be used in the treaty article. It was pointed out by several members that words such as "tax evasion" and "tax avoidance" had different meanings under different legal systems, especially regarding the question of criminal responsibility. The Ad Hoc Group discussed whether information required to assure compliance with the domestic laws of a contracting country should be included. One member from a developed country pointed out that some of those laws might be so drastic as to make their inclusion undesirable. The Special Adviser to the Rapporteur felt that most problems of definition would be eliminated if the conditions under which fiscal information should be exchanged were thoroughly discussed and settled in the course of actual treaty negotiations.

151. A member from a developed country referred to the extraordinary difficulties and burdens on a reporting country which might result from the fact that the information submitted by the reporting country was not in accordance with the procedural requirements of the other treaty country. The consensus of the Ad Hoc Group was that such difficulties would not detract from the desirability of fiscal exchanges as such, but the experience indicated problems that had to be solved.

152. A member from a developing country submitted a tentative draft replacing paragraph 1 of article 26 of the OECD Model Convention. The member explained that the words "fraud" and "evasion" used in his draft referred to illegal non-payment of taxes. Regarding the statement in the draft that the information transmitted might be disclosed to a court of law, the member explained that the country which furnished the information would be free if it so desired to impose conditions to ensure that such information would not be made available to the public.

153. A member from a developed country agreed in principle with the draft. He suggested that the words "concerning taxes covered by this convention", which are eliminated in the draft, might be inserted after the words "or for the prevention of fraud or evasion". The Special Adviser to the Rapporteur suggested that the beginning of the last sentence of the draft might be amended to read "Any information so exchanged shall be treated as secret but may be disclosed to any court or other agency concerned with the collection of Taxes...". The purpose of the latter recommendation was to clarify that the term "court of law" did not cover tribunals in which tax matters were dealt with only incidentally. The

Special Adviser to the Rapporteur further explained that the words "appropriate conditions" should be understood to cover expenses and similar items regarding the information. There was general agreement that the word "courts" included criminal as well as civil courts dealing with the collection of taxes.

154. A member from a developed country expressed some misgivings about including the term "avoidance of tax" in the tentative draft without further clarification. The member felt that the term might leave room for dispute between the tax authorities and the taxpayer as to what information the tax authorities would be legally entitled to exchange. The member preferred that this term should be defined more precisely, and suggested that if a more precise definition was not generally acceptable, it might be better to omit the term from the article and add in a commentary that some countries would wish to include legal avoidance in the article in bilateral negotiations. A member from a developing country agreed with this statement and emphasized that necessity of a consistent application of the terms "avoidance" and "evasion", both of which were used in the draft article.

155. The member continued the discussion of the problem that tax information that was disclosed in open court would easily be available to the customs or exchange control authorities of the receiving country, observing that such publicity might hinder rather than help the exchange of fiscal information. It was suggested that the text of the draft might be altered so as to make disclosure of information to a court of the other country subject to in-camera proceedings, or that the consent of the other country to such proceedings might be sought. It was agreed that the two Governments were always in a position to come to an agreement concerning the extent of the use to be made of such information. The Special Adviser to the Rapporteur added that a country negotiating a tax treaty could always ask the other country to explain the procedures which it applied in the assessment, collection and enforcement of its taxes and make reservations regarding the transmission of information in the light of those procedures.

156. The members then discussed the question whether the draft article should be amended to include a reference to the domestic laws of the contracting countries, as under article 26 of the OECD Model Convention. The member proposing the draft article felt that this insertion was unnecessary because the entire range of information sought by a treaty country was covered by the draft, especially as a result of inserting the words "fraud" and "evasion". The Special Adviser to the Rapporteur explained the draft article was intended not to be more restrictive than article 26 of the Model Convention, but to go beyond the model article by referring specifically to the aspects of fraud, evasion and avoidance where appropriate. Other members felt that the general text of the model article should initially be retained and then amplified as desired. Members then agreed that general approach of the tentative draft should, for the time being, be accepted, but that the question whether the reference to the domestic laws of the contracting countries should be made, as well as other possible drafting changes, should be considered further.

157. The Special Adviser to the Rapporteur read the proposed text of revised article 26, paragraph 1 of the Model Convention.

158. The members then entered into a brief debate of the draft article.

159. A member from a developing country thought that the draft article was more restrictive than comparable provisions in the treaties concluded by his country, because none of the draft provisions were made mandatory.

160. The Special Adviser to the Rapporteur considered that the draft article covered the domestic laws of the contracting countries as well as fraud, tax evasion and tax avoidance. In the Special Adviser's opinion, the most important part of the draft article was its second sentence, which made it incumbent on the competent authorities of the contracting countries to consult with each other on the development of appropriate conditions, methods and techniques concerning the subject matters of the exchanges. Notwithstanding the insertion of an exchange of information article in a tax treaty, Governments might find difficulties in exchanging fiscal information. Accordingly, it would be prudent to recognize these difficulties and to phrase the model article so as to remove the difficulties so that a country possessing information would be in a position to exchange it with the other treaty country.

161. A member expressed the view that information on a particular tax should be exchanged even in a situation in which a treaty dealing with that tax might be in a limited form so that some items were excluded from coverage of the convention. The member further suggested changes to paragraphs 2a and 2b of article 26 of the Model Convention, which in his opinion were much too restrictive.

D. Summary by the Special Adviser to the Rapporteur

162. The Ad Hoc Group expressed general agreement to a modification of article 26 of the OECD treaty along the following lines.

163. The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention, in so far as the taxation thereunder is in accordance with this Convention, in particular for the prevention of fraud or evasion of such taxes. The competent authorities shall, through consultations, develop appropriate conditions, methods and techniques concerning the matters respecting which such exchange shall be made, as well as exchanges of information regarding avoidance of tax where appropriate. Any information so exchanged shall be treated as secret, but may be disclosed to any persons (including a court or administrative body) concerned with the assessment, collection, enforcement or prosecution in respect of the taxes which are the subject of the Convention.

164. Article 26, paragraph 2 of the OECD Draft Double Taxation Convention 8/ stipulates that:

"2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:

"(a) To carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;

"(b) To supply particulars which are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

8/ Organisation for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital (Paris, 1953), p. 58.

"(c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public)."

Commentary

165. The reference in the above draft to fraud or evasion is intended to focus attention on the importance of including exchanges of information that will assist the treaty partners in combating those practices. The term "evasion" is used here in the sense of an illegal act. Since a number of countries are also concerned with the need for information to assist in the administration of specific statutory provisions against tax avoidance, and others are concerned with information to assist in detecting other aspects of tax avoidance, the draft makes reference to exchanges of information on tax avoidance activities where the treaty partners consider exchanges in this area to be appropriate. Further the draft emphasizes that the competent authorities should, through consultations, develop the conditions to govern the exchanges of information between them for the various matters on which they consider such exchanges should be made. These consultations on such conditions, together with consultations on methods and techniques, will enable the two treaty partners to develop the background, subjects, procedures and the like that will shape the exchanges of information between them. Such consultations on conditions, for example, might include the appropriate method of proceeding when it was contemplated that the information might be utilized in a court of law and thereby become public. As another example, the consultations could deal with the scope of exchanges regarding the carrying out of domestic laws in situations in which a treaty might be limited to only a portion of the substantive areas usually covered in a tax convention. Also, the exchanges could extend to exchange of information and ideas on techniques to enforce compliance with tax laws developed in one or another of the countries.

166. The Group agreed that, now that a consensus had been reached on the terms of a draft treaty article on exchange of information, it was important to consider other aspects of the subject that had been discussed. Thus, it was recognized that differences under domestic laws on the extent of the authority of tax administrations to obtain information had an effect both on the ability and willingness of the tax administrations to enter into exchanges of information. Such unevenness in authority, for example, could present difficulties for those administrations with wide powers to secure information to exchange it with a treaty partner that also had treaties with countries in which the tax administrations had narrower authority. The Group therefore felt it would be useful to obtain information on the extent to which such authority differed among tax administrations, and then to consider how best to meet this unevenness and to bring about changes or procedures conducive to those exchanges of information that would be most effective in countering escapes from taxation. Further, to prevent competitive difficulties among taxpayers in various countries, some covered by treaties and some not, it would be desirable to promote as wide a coverage of exchange of information as possible. In all such situations it would be necessary to see how much progress could be made bilaterally, and when it was appropriate or necessary to resort to multilateral measures, and if so, the nature of such multilateral measures.

167. Further the Ad Hoc Group recognized that certain tax provisions or administrative practices which could be regarded as having a harsh, unfair or discriminatory effect on residents of another country might in themselves have

an inhibiting effect on the willingness of the tax administrators of that country to exchange information, and it would therefore be appropriate to explore such situations to see if they could be improved. In some situations, this could require a reconsideration of substantive matters, such as the treatment by a source country of an employee or other person as a resident of that country subject in full to its tax laws, even where it was clear that his residence was essentially transitory or not permanent. In other situations, this could require consultations between the competent authorities on the purposes for which information was being sought, thereby leading to the formulation of appropriate conditions and guidelines designed to deal with factors regarded as obstacles to exchanges of information. In any such consultations, consideration could be given to differences in approach, where feasible, between requests for information regarding nationals of the requesting country and requests regarding nationals of the requested country.

168. The Ad Hoc Group also recognized the need for further discussion of the appropriateness of co-operation between treaty countries in the rendering of assistance in the collection of taxes.

169. Since no further objections were raised the Chairman stated that the Ad Hoc Group was in general agreement with the redraft of article 26, paragraph 1. The Ad Hoc Group then adopted the first portion of the report (ST/SG/AC.8/R.42), with the corrections made thereto, the second part of the report, "Scope of Royalties" and the third part of the report, "Dividends" (ST/SG/AC.8/R.42/Add.1 and ST/SG/AC.8/R.42/Add.2). The Chairman then read the corrections to these portions of the report paragraph by paragraph (Corr.1 to R.42/Add.1 and Add.2). There were no objections to these corrections except for slight drafting changes of which note was taken.

170. The Ad Hoc Group then proceeded to discuss the next topic.

IV. METHODS OF ELIMINATING DOUBLE TAXATION, INCLUDING TAX SPARING

A. General discussion

171. While discussing the fourth item on the agenda, the Ad Hoc Group had before it papers on tax sparing (ST/SG/AC.8/R.40) and alternative measures (ST/SG/AC.8/IV/CRP.1/Rev.1), including the questionnaire sent out by the Secretariat and the replies received thereto from various countries (ST/SG/AC.8/IV/CRP.2 and addenda). Reference was also made to chapter VII of the third report. 8/

172. A member from a developing country stated that he had prepared a document analysing the proposals made by the Secretariat, which would be translated and distributed.

173. Summarizing this document, the member stated that the working papers prepared by the Secretariat provided a good general background for the study of the problem. Considering the lack of unanimity within the Group with respect to tax sparing and alternative relief measures, the member realized that it had not been possible for the Secretariat to distribute the documents at an earlier time. On the other hand, this delay made it impossible for the members to formulate final views at this meeting. Speaking for himself, the member stated that he could not at this point support any of the relief measures that had been proposed as a substitute for tax sparing. The member did not preclude the possibility that he might change his view after the tax authorities of his country had had an opportunity to study the proposals.

174. The member stated that he did not wish to offer views on the issue of tax sparing because the views of the developing countries, and his country in particular, on this question were well known.

175. Concerning the suggestion that developed countries make certain payments to an international financing organization to the extent that they profited from tax sparing measures applied by developing countries (ST/SG/AC.8/IV/CRP.1/Rev.1, paras. 74 and 75), the member acknowledged that this mechanism, although it was complicated and its application might arouse suspicion, had aspects that merited careful consideration. With respect to the proposal of a sale and leaseback of industrial properties for tax purposes, the member felt that the proposition was very complicated and not sufficiently clear in its present form, especially, for example, with respect to the important question of how adequate rentals, market rental and profits should be determined. In the member's opinion, the argument that this method would effectively eliminate the problem of expropriation was not

8/ Tax Treaties between Developed and Developing Countries: Third Report
(United Nations publication, Sales No. E.72.VI.4), chap. VII, pp. 92-104.

convincing because the developing countries might, after all, for example, suspend the lease as such or cancel it.

176. Summarizing his views, the member stated, as his preliminary view, that none of the alternatives to tax sparing seemed to meet the requirements of the developing countries. Subject to a more thorough review, these alternatives appeared to be only inadequate substitutes for simple and straightforward methods, such as tax sparing, of assisting the developing countries. However, once a careful study of the various methods and their effects had been made, it might well be that one or the other might merit a different approach.

177. A member from a developing country referred to the extraordinary difficulties which this group of countries encountered in obtaining the capital required for their economic development. While it could be denied that funds were currently made available by industrialized countries, such investments were made dependent upon compliance with a number of conditions, including, among others, political stability, acceptable infrastructure and the expectation of substantial profits. Even so, such investments as were actually made were entirely disproportionate to the needs of the developing countries. Accordingly, countries which accepted these investments must also accept heavy sacrifices in order to obtain them. Subsidiaries of developed country corporations which utilized the benefits that were extended by developing countries, sometimes for a considerable number of years, realized substantial profits and even distributed dividends to their shareholders without contributing anything to the treasury of the developing country. If a developed country did not recognize the tax-sparing credit, the sacrifices made by the developing country actually inured to the investor's home country rather than the investor for whom they were designed. The member referred to the study on tax sparing and alternatives submitted by the Secretariat and expressed his satisfaction with the clarity and objectivity of this document.

178. The member felt that the sale and leaseback proposal was perhaps too complicated and should be the subject of further study. Concerning the proposed payments by the developed country to an international fund, the member felt that this method was not very likely to stimulate specific investment decisions. In summary, the member expressed a preference for the tax-sparing credit, which had the advantage of being the most simple of all measures proposed from the point of view of tax administration, and which had already been included in a number of tax conventions and had thus been tried out in practice.

179. One disadvantage of the tax-sparing credit was that it was apt to encourage premature repatriation of profits. It would therefore be necessary for a developing country to make the credit subject to conditions which assured the reinvestment of profits for a reasonable time. Existing tax treaties which included a tax sparing credit had not considered this aspect. If this safeguard was applied in proper form, it would help the developing countries as well as the developed countries by regulating the volume of capital transferred.

B. Alternative measures to tax sparing

180. A member from a developing country stated that tax-sparing and alternative methods had been discussed at the last-preceding meeting of the Ad Hoc Group. It

was well known that the developing countries sacrificed substantial amounts of revenue through tax exemptions, reductions of rates for limited periods or certain types of income, as well as outright subsidies. They also granted special incentives for the reinvestment of profits. The member's home country had concluded tax treaties with several developed countries that included a tax-sparing credit. The treaties so far concluded did not provide for tax-sparing in respect of the various methods of tax relief referred to; this required further consideration. Concerning developed countries which rejected this method, it was obvious that other techniques alleviating the situation would have to be found. The member felt that among the alternative methods proposed, the investment credit presented problems where these measures were divorced from those adopted by the developing country and related to income or invested capital. The proposed leaseback appeared promising at first sight because the developing country had control over the investment, the taxpayer received a benefit and the developing country was not deprived of revenue. This method, however, seemed to require close co-operation between the investor's country and the developing country to ensure that the investor could actually rely on the benefits made available to him, even under changing market conditions. The member felt that it would also be desirable for the interest to be exempted from tax by the investor's home country.

181. The member suggested the following as a simple alternative to the leaseback proposal, to be applied by developed countries which did not recognize the tax-sparing credit. The investor would pay the tax of his home country with credit for the tax of the developing country in which the investment was made. The latter country in turn would reduce its tax to the level of the tax of the developed country. Accordingly, the taxpayer could never be faced with a greater tax than that of his domicile. The investor's home country should also provide for a reduced capital gains tax upon the disposition of the investment.

182. A member from another developing country pointed out some of the advantages of the leaseback proposal, such as retention of the ownership by the developing country. The member felt that determination of the proper rental would be difficult and that this method would not permit participation in the investment by investors from the developing country. The purpose of the proposal was to give the investor the same return on his capital as he could expect from the tax-sparing credit. The leaseback proposal would result in a heavier financial burden on the developing country than tax sparing. The member did not rule out the possibility that the leaseback proposal might be improved to the point where it should be seriously considered.

183. A member from another developing country felt that the analysis of alternatives suggested in the paper was indeed admirable, but agreed that the leaseback proposal was complex and that it would be desirable to find a simpler solution. According to the member, the tax incentives extended by developing countries applied to both domestic and foreign investors. As far as the latter were concerned, care should be taken to ensure that the benefits extended by the developing country were reaped by the investor and not by the treasury of his home country. Considering that industrial investments were usually not very profitable during the initial years, the Government of a developing country might consider to pay the investor a certain percentage of the invested capital for a limited number of years to make up the difference between the actual return on the invested capital, if any, and the normal return on investments of this kind.

184. A member from another developing country felt that, unlike the tax-sparing credit, there was no actual experience at this time concerning the leaseback proposal. It was, in particular, not clear how businessmen from developed countries would react to this proposition. If the result of the study was favourable, there was a possibility that developing countries might wish to experiment with this method.

185. A member from a capital-exporting country stated that his country's experience with the tax-sparing credit had been favourable, and that his Government would prefer to stay with this measure rather than adopt one of the alternative methods proposed. The member pointed out that the tax-sparing credit was conditional on the application of tax incentives in the developing countries and that it could be extended, under the provisions of the treaty, by agreement of both parties at the administrative level whenever such measures were introduced by a developing country, thus making this method flexible.

186. The Ad Hoc Group approved the parts of the report dealing with intercompany dividends, portfolio dividends and exchange of information, with the corrigenda issued thereto.

C. Methods of eliminating double taxation

187. A member from a developing country who reviewed the various incentive measures offered by his home country mentioned, in particular, the exemption granted to foreign experts performing work that was of interest to his Government. The member mentioned that only one of the tax treaties concluded by his country provided that such remuneration should also be tax-free in the expert's home country. In the opinion of the member, this rule should be generally applied, at least where the expert's stay in the developing country was of substantial duration.

188. The member further referred to cash subsidies granted by some developing countries. The member noted that his home country granted such subsidies to all major agricultural producers, regardless of whether they were residents or non-residents. In this area too, reciprocal benefits by the home country of a foreign investor were called for because the benefits offered by the developing country would be nullified if the subsidy were treated as taxable income at the investor's domicile.

189. The member concluded that the relief measures so far extended by developed countries were insufficient. This was true, in particular, of tax sparing, which was presently applied only to dividends and a few other items of income. Since the Ad Hoc Group had accepted the principle of revenue sharing between developed and developing countries with respect to various types of income, it should now express itself in favour of a universal application of this principle. A developed country that presently considered a tax-sparing credit unacceptable might perhaps be willing to grant a deduction from income for the tax spared by the developing country. Conversely, the developing countries should endeavor to

find some way of benefiting foreign investors outside the principle of tax exemption. The member finally recommended that the areas of tax sparing and exchange of fiscal information be studied in depth before the next meeting of the Ad Hoc Group. Members should also obtain the opinions of their Governments on these questions and distribute this information among themselves before the next meeting.

190. With respect to the leaseback proposal, the member felt that the developing countries, apart from a guarantee against the risk involved, would need help in two areas, namely, (a) in connexion with the repayment of the credit; and (b) the possible expansion of the credit, if this became necessary. Another problem in this context was how the host Government should deal with an enterprise that was not able to meet the conditions of the contract. Another approach would be to extend assistance to the investor by taxing the gain realized at a reduced (capital gains) rate.

191. A member from another developing country expressed his complete agreement with the member from a developed country who had expressed himself in favour of tax sparing as the preferred relief measure. The member pointed out that as long as developing countries had economic difficulties, they would look for foreign investors and extend certain incentives to them. Tax sparing was a very important relief measure, especially because it preserved the benefit of the incentive to the investor. Among the alternative methods proposed by the Secretariat, the investment credit might be useful, although further study of this proposal was needed. It should be clarified whether developed countries which considered themselves unable to grant a tax-sparing credit would be willing to adopt any of the alternative measures proposed.

192. With respect to the leaseback proposal, the member noted that two principal points should be considered. One was that the Governments of the investor's home country and the country in which the investment was made must co-operate in computing the profits of the corporation of the resident country on the normal and not the reduced rentals. This would result in tax sparing.

193. The member then discussed the alternative proposal under which cash grants would be made available to developing countries by an international fund. The member pointed out that he had attempted to have a similar proposal discussed at a prior meeting, but that the Ad Hoc Group had rejected discussion of this proposal as not being within the framework of a conference dealing with fiscal matters. Concerning the present proposal under which the amount of taxes paid by the developing countries would be paid to an international fund by the developed countries, the member felt that these funds would be merged with others and that their origin would be forgotten. He pointed out that the author of this proposal (ST/SG/AC.8/IV/CRP.1/Rev.1, para. 76) had himself stated that "The plan in itself would admittedly offer no direct incentive to any particular foreign-owned firm."

194. The member stated that it was important for the Secretariat to examine alternative measures as long as some countries refused to apply tax sparing. It was also important to know whether the Governments of the developed countries would be willing to adopt one or the other of those methods. As long as none of the alternative measures was accepted, tax sparing would seem to be the preferred method.

195. An observer indicated that reciprocity of recognition of incentives was not always required. He illustrated this by reference to the methods of financing large enterprises in this regard and also related his remarks to the leaseback proposal. No Government would be willing to extend or underwrite financing of enterprises requiring the investment of hundreds of millions of dollars. Only large banks, insurance companies, pension funds and similar private financial enterprises could be expected to finance investments of this magnitude. Without exception, these financial institutions would protect themselves by demanding that 75 or 80 per cent of the cash flow during the first 8 or 10 years of the operation be used to repay the loan and pay the interest thereon. Accordingly, investors could not expect dividends during that period. The observer referred in this context to a major complex in South-East Asia with a cost of \$400 million, which had borrowed another \$300 million from international banks. Investments of this size obviously could not be financed with the help of the proposed leaseback method, considering that ownership of the properties would be transferred to the host country and that no Government could possibly incur a \$300 million debt for industrial investments plus long-term interest thereon in its budget. Even more important, no host country would be willing to accept financial responsibility in the event that the venture should fail. Risks of this magnitude were undertaken only by major financial institutions.

196. The observer mentioned that the leaseback proposal had other problems. Under the proposal the subsidiary operating in the host country would have to look to its parent in the developed country for payment of the debt. The parent in turn would not rely on any collateral available because the operating assets were owned by the host country and not by the subsidiary. The observer stated in summary that while the leaseback proposal might be workable for investments of minor size, such as those shown in the numerical examples submitted, it was unworkable where major enterprises were involved.

197. A member from a developing country stated that he was in full agreement with the observer. Since tax sparing had been discussed by the Group since its second meeting, the Group should now state that most members from developed and developing countries were in favour of this method, even though one or the other country might find this method unacceptable. Notwithstanding the excellent documentation prepared by the Secretariat, it might be desirable to devote further study to this point. A member from a major capital-exporting country stated briefly that his home country applied the tax-sparing credit in a number of tax treaties.

198. A member from a developing country recommended that further studies be devoted to the alternative methods proposed, although tax sparing seemed to be superior to any of them. Members had not had an opportunity to study the Secretariat papers in detail. The member recommended that the Secretariat collect information on the practical effect of various incentives extended under tax treaties and draft a questionnaire to be addressed to Governments asking for their experience and recommendations. Apart from the incentive measures presently discussed, the member suggested that information on the secrecy of bank accounts and similar questions that were relevant in connexion with the exchange of information also be obtained so that the Group could arrive at definite conclusions concerning these matters at its next meeting.

199. Another observer said that Secretariat documents should discuss how certain weaknesses and abuses attributed to the tax-sparing method could be overcome. The observer did not believe that tax sparing stimulated premature repatriation of profits. Whether an investor would repatriate his profits or reinvest them was decided as a matter of experience solely on the basis of business considerations.

200. A member from a developing country agreed that tax sparing had certain disadvantages. One disadvantage was that his method resulted in pressure on the developing countries to give up sources of revenue. Even so, the member suggested that the principle of tax sparing should be accepted by the Ad Hoc Group, but that efforts should be made to find an alternative solution for countries that were not willing to accept this method. The member felt that the leaseback arrangement was inferior to tax sparing because of its complexities. Perhaps other ideas could be developed by the Secretariat before the next meeting of the Ad Hoc Group.

201. A member from a developed country applying the tax-sparing credit pointed out that several important questions had not been discussed by the Ad Hoc Group. The first question was whether the developing countries should forgo part of their tax revenue in order to attract foreign investment. This was a question which the developing countries had to decide for themselves and not a matter for negotiations. However, another member from a developed country was of the opinion that the provision of the tax-sparing credit should be conditioned on the tax-incentive measures on the part of the developing countries.

202. The member pointed out that far from maintaining a neutral attitude in this matter, a developed country refusing to adopt the tax-sparing credit actually exercised pressure on the developing country to collect its full taxes, thus interfering with the latter's free decision on this point. In effect, a developed country which took this position attempted to dictate the tax policy of the developing country. Such a position was neither defensible as a unilateral decision of the developed country nor a proper subject of tax treaties. If a developing country decided to give certain incentives to investors, a developed country entering into a tax treaty with it should make these incentives fully effective by granting a tax-sparing credit rather than take the incentives away. The member observed that there were other problems connected with tax sparing that might be studied, some of which resulted from differences in the incentives offered by various developing countries. In the member's opinion, under the leaseback proposal, interest would flow from the developing to the developed country, thus reducing the alleged economic benefit to the latter.

203. The meeting continued the discussion of methods to eliminate double taxation. A representative from a developed country suggested that the problem of tax-sparing credits involved political issues in addition to economic considerations. Some circles considered that investment in the developing countries should not be artificially encouraged because an atmosphere was sometimes created in which, instead of being welcome, foreign investors were accused of reaping exorbitant profits and faced expropriation, particularly when they benefited from incentives not available to domestic investors. Thus, in a number of cases, properties in recent years had been expropriated without adequate compensation on the ground of the allegedly large profits made in the past. Consequently it might be

imprudent for developing countries to extend incentives to foreign investors which those countries were not willing to extend to their own nationals. There were significant economic problems associated with tax-sparing credits, in part because they encouraged withdrawal of profits. Thus, the effectiveness of tax incentives protected by tax sparing might be questioned because it might sow the seeds of future discontent.

204. With respect to the leaseback proposition, the member pointed out that this proposal originated in certain technical legal provisions, as a result of which government subsidies might be treated as contributions to the capital of a corporation. In view of the problems associated with a tax-sparing credit, it seemed appropriate to consider an alternative approach; for example, it might be possible for a country to assume the ownership of a plant nominally and turn it over to an investor. The taxes paid by him on his profits would in effect go to pay for the loan of money for the plant. The plant would thus actually pay for itself over a period of time. Since the investor would pay taxes in the host country, he would be granted a foreign tax credit in his home country.

205. Applying this principle to investment in developing countries, the leaseback plan was developed, which would have the same result as a tax-sparing credit. However, the leaseback plan appeared to be a highly complex illustration of the principle.

206. The member was of the opinion that the Ad Hoc Group might not be sufficiently versed in the technical intricacies of the law involved to fully assess the merits of the leaseback proposal. He suggested that any developing country which seriously considered entertaining this approach should consider seeking specialized expertise. He thought that such a scheme might be set up under the existing law rather than pursuant to tax treaties.

207. A member from another developed country felt that while it was true that some of the alternatives were influenced by the law of the country in which they originated, this fact should not preclude a detailed study of the proposals, which so far had not been possible.

208. A member pointed out that his country had concluded treaties that included tax-sparing clauses with a great number of developing countries, and that there was considerable variety concerning the manner in which the credit was applied under the various treaties. Other treaties provided a flat credit for certain withholding taxes of developing countries, regardless of the actual rate of the tax.

209. With respect to the subject of expropriation, the member stated that his country's experience had not been unfavourable because it would conclude treaties only with countries with which it had satisfactory political relations.

210. A member from another developed country pointed out that in essence, the proposal envisaged that a corporation in an industrialized country would make a loan to a developing country, which then used the funds to provide the plant and machinery. The developing country, as the recipient of the loan, would pay

interest to the company which had provided the money. However, the paper setting out the leaseback proposal failed completely to answer the question of whether such interest would receive any tax benefit in the investor's home country, either in the form of a tax-sparing credit for the withholding tax of the developing country or in some other form.

211. In addition the proposal envisaged that the profits of the subsidiary in the developing country would be increased by reducing the rental paid by it to the Government of the host country. In the member's opinion, the developed country would thus be asked to give a credit for an artificially increased tax on artificially increased income. The same procedure would be applied to the withholding tax of the developing country. The member doubted that proposals of this kind would ever be approved by a country which refused to grant the normal tax-sparing credit. The member felt that additional information was needed for a full evaluation of this point.

212. The Special Adviser to the Rapporteur remarked that the problem was essentially one method under which developing countries would offer financial support to prospective investors in order to stimulate investment in their area. Channelling money to the investors through the tax system would create problems if the investor's home country did not recognize a tax-sparing credit. Accordingly the developing countries would look to other ways of extending financial support to the investor. The leaseback proposal attempted to reach this goal by reducing the rentals for the use of the industrial facilities. The problem was how to separate financial assistance by a developing country from the tax system of the developed country, so that the latter could not refuse to permit the use of the regular foreign tax credit. The Special Adviser to the Rapporteur suggested that further analyses of the leaseback and other proposals be made by the Secretariat to clarify what legal problems might exist with respect to such proposals in a country applying the regular foreign tax credit.

213. A member from a developing country suggested that information be collected on whether the proposed alternative relief measures would be acceptable to businessmen in the developed countries and whether the Governments of these countries would be prepared to include such measures in their tax treaties. The member further suggested that an investigation be made to determine the extent to which tax sparing had played a role in channelling investments to developing countries. Any available statistical information should be utilized. The member expressed his conviction that the developing countries had made extremely heavy financial sacrifices to attract foreign investment and should therefore be in a position to know whether these incentives were in fact attracting foreign investment or whether they were insignificant in comparison to the expectation of substantial profits.

214. A member from a developed country agreed that it would be most desirable to make a thorough examination of incentive measures. The member added that he did not want to be understood as questioning the technical ability of the Group to evaluate tax incentives; his remarks in this direction only concerned certain technical points in the leaseback paper. Moreover, this memorandum should not be considered as a definite proposal, but merely as a starting point for simpler alternative solutions.

215. A member from a developing country felt that the Group was losing sight of the purpose for which it had been established. Each country must decide for itself how to promote its economic development. Corporations from developed countries invested in developing countries because of the profit opportunities offered by investments in such countries, provided that they also offered political and economic stability. Up until now the Group had not found any relief measure that was better than tax sparing, and this point should be made quite clear in the report without prejudice to further studies of other and as yet unexplored measures.

216. A member from another developing country agreed that the report should reflect the position of the developing countries that tax sparing had been found to be the simplest and most effective relief method, and that such weaknesses as the method might have were of no great consequence. The member referred to document ST/SG/AC.8/R.39, in which it was demonstrated that the tax incentives by his country had not really become effective until they were matched by tax-sparing credits in the developed countries. Clearly the importance of this combination of tax sparing by the developed countries and tax incentives of the developing countries should be clearly pointed out in the report.

217. With respect to the leaseback proposal, the member pointed to the risk of ownership which developing countries took under this proposition and said that this obstacle would have to be carefully considered before the proposal became feasible. The member felt, however, that a treaty could be concluded on this basis, provided that the developed country agreed not to tax non-repatriated profits and to uphold the exemption of subsidies given by the developing country. If the tax incentives provided to the foreign investor were to be withdrawn it had to be in a provision in the treaty. Specific amendment to the law would not be feasible.

218. A member from a developed country pointed out that it was much easier in the experience of his Government to make tax concessions than to pay subsidies. The important point was that any monetary advantage which the investor received from the developing country should be preserved. The question was whether this purpose and the application of the regular foreign tax credit could be accomplished. In the final analysis, the leaseback arrangement might suffer from the same defect as the tax-sparing system itself. The member also recommended further study of the leaseback proposal.

219. A member from a developed country emphasized that the report should state three facts which had become quite clear in the course of the discussion, as follows: (a) there was general agreement within the Group concerning the merits of the tax-sparing credit; (b) tax-sparing credits had been applied in many tax treaties; accordingly, there was an existing tradition concerning this relief measure; (c) the Secretariat should undertake a deeper analysis of the advantages and disadvantages of the tax-sparing method and techniques, and obtain statistical information reflecting experience with this credit and its influence on the flow of capital. In addition, other relief measures should be studied to meet the situation arising from a refusal to accept the tax-sparing credit.

C. Summary by the Special Adviser to the Rapporteur

220. The members from the developing countries clearly expressed the viewpoint that, in view of the tax incentives which they were offering to attract investors, the use of tax-sparing credits by residence countries having the credit method for relieving double taxation was an effective method of granting recognition to those tax incentives and ensuring that the incentives would benefit the investor. The developed countries represented had for the most part utilized a tax-sparing approach in their treaties; the members from those countries joined in this recognition of tax sparing as an attractive scheme for the investor and a workable approach to the tax administration. Both sets of members thus regarded tax sparing as an approach presently available that was workable and desirable and that had been utilized over a period of time. The tax-sparing scheme has the merit that the developed country did not take for itself any of the benefits given to the investor, and its merits were recognized by all developing and many developed countries.

221. It was further recognized, however, that a difference of opinion did exist in this matter since the tax-sparing credit approach was not used by all developed credit countries. A member from a developed country stated that there were, in the minds of some, serious problems with the tax-sparing credit approach as an inducement to be offered by developed countries to their investors to lead them to invest in developing countries. Apart from the issue of whether such inducements in the long run created atmospheres of conflict rather than harmony among countries, some of these problems grew out of the fact that the tax-sparing credit device could by its very nature recognize only those financial sacrifices made by a developing country that were in the form of tax incentives and could then come into play when repatriation of profits occurred. Also, while developing countries looked upon a refusal of developed countries to grant tax-sparing credits as an interference with and blocking of the policies of the developing countries, and some developed countries also shared this view, other developed countries could see the picture the other way and could regard the demand for tax-sparing credits as an interference with the policy of a developed country seeking neutrality for its investors.

222. It was apparent that, so far, even after an extended discussion within the Group, those seeing the tax-sparing credit as the best way to approach the matter and one that was utilized and workable could not convince those critical of tax-sparing credits. Nor, at the same time, could those critical of the tax-sparing approach convince the advocates of tax-sparing credits of the defects and problems of that method.

223. In this posture, it was agreed that further useful steps could nevertheless be taken. As for the tax-sparing credit itself, it would be helpful to analyse the extent to which tax-sparing credits were used in existing treaties, the particular techniques followed and whether they could be extended to additional items. It would be helpful also to analyse further the advantages and disadvantages of tax-sparing credits, and to see if statistical data, beyond that already in the documents, could be obtained indicating whether and to what extent tax-sparing credits, and indeed the tax incentives themselves on which tax-sparing credits necessarily rested, brought about a significant inflow of desired investment considering the financial costs of those incentives to the developing countries and of tax-sparing credits.

224. As another path of study, since not all developed countries were willing to utilize the tax-sparing credit, it was agreed that it would be useful to study alternative approaches to tax-sparing credits that could be followed by the treaty partners in case a developed country did not desire to incorporate a tax-sparing credit in a treaty. Since the basic objective of tax-sparing credits and the tax incentives involved was to provide financial assistance to investors, the study would thus at least extend to seeking alternative forms of assistance to be used by a developing country which was willing, in the first instance, to grant such assistance solely for the benefit of the investor. It was recognized that grants, favourable loans, subsidies, a guarantee of a minimum profit level for an initial period, the provision of facilities for the enterprise and the like were methods of assistance that should be considered. The consideration would involve both whether the techniques were feasible for the developing country to offer and whether they would be workable, in the sense that any taxes paid by the enterprise in the developing country would be regarded by the developed country as qualified for full tax credit even though the enterprise was receiving such assistance in the developing country. This latter aspect could of course itself be an appropriate subject for inclusion in a tax treaty. In this regard, the leaseback arrangement described in the documentation, which offered assistance through lease terms of government-owned facilities at below-market levels, could also be studied from such standpoints. In addition, all such methods of non-tax assistance offered by a developing country would also have to be analysed from the viewpoint of their financial feasibility and realistic utility to the investor.

225. It was further recognized, again with reference to a developed country that did not utilize tax-sparing credits in its treaties, that situations should be studied in which the absence of a tax-sparing credit by the developed country would not offer any real obstacle to the effective utilization by a developing country of tax incentives as the method of financial assistance to investors, with any part of such assistance going to the benefit of the developed country. Thus, if a subsidiary in a developing country were using the profits of its initial period of operation to pay off the borrowed capital that financed the enterprise, then tax incentives granted that subsidiary by the developing country would be of immediate aid to the enterprise without any resort to a tax-sparing credit by the developed country. This would also be the case if the profits were being reinvested by the subsidiary. There might well be other ways in which the subsidiary's profits were being utilized that did not involve a direct repatriation to the parent or other payment to the residence country, which was the only situation that would produce a basis for tax-sparing credits.

226. Also, assuming a developed country was itself desirous of providing inducements to its investors to invest in developing countries, but not to use a tax-sparing credit approach or other aspect of its tax system, then here also there would be an opportunity to consider what forms of financial assistance through the use of expenditure techniques were available for this purpose and could be utilized or recognized in tax treaties.

V. FUTURE WORK AND OTHER QUESTIONS

227. The Ad Hoc Group then proceeded to discuss the agenda for the next meeting. It was informed that there were as yet the following unfinished topics:

- (a) Methods for the elimination of double taxation and tax incentive problems
- (b) Exchange of information
- (c) Interest on deferred credits
- (d) Leasing
- (e) Non-discrimination
- (f) Treatment of non-permanent residents
- (g) International income allocation
- (h) Income from immovable property
- (i) Capital gains

In addition, there might be other problems meriting discussion, such as the avoidance of double taxation in respect of wealth taxes imposed in a number of countries.

228. Another member suggested adding the discussion of domicile (article 4 of the OECD Model Convention). The Ad Hoc Group then briefly discussed the time and place of the next meeting. The decision on these matters was left to the Secretariat.

ANNEXES

ANNEX I

Economic and Social Council resolution 1541 (XLIX). Tax treaties between developed and developing countries

The Economic and Social Council,

Recalling its resolution 1273 (XLI) of 4 August 1967 and 1430 (XLVI) of 6 June 1969 on tax treaties between developed and developing countries,

Having considered with satisfaction the progress report of the Secretary-General and the second report of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries,

Noting the Group's unanimous view endorsed by the Secretary-General that substantial progress has been made in evolving suitable specific guidelines for tax treaties through the study and formulation of texts of solutions which had the general support of the members of the Group,

Considering that the mutual accommodation of differing interests is of great importance for international tax relations between developed and developing countries, and that the guidelines already formulated by the Group represent an important form of technical assistance for the conclusion of future treaties,

Welcoming the Group's consideration of the questions referred to it by the Secretary-General of the United Nations Conference on Trade and Development on how the tax treaty provisions on the exchange of information could be utilized to combat tax evasion and capital flight,

Mindful of the great satisfaction expressed by the Committee for Programme and Co-ordination with the work of the Ad Hoc Group of Experts,

Noting with great interest that the Committee for Programme and Co-ordination unanimously endorsed the recommendation of the Secretary-General that the third meeting of the Group be convened in 1971, as recommended by the Group, to continue its successful work,

1. Requests the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries to continue its work as envisaged in operative paragraph 1 of Council resolution 1273 (XLI);

2. Requests the Secretary-General to convene the Group in 1971, preferably in the first quarter of the year, and to make the appropriate financial allocation to enable the Group to continue its work;

3. Invites the Secretary-General to report to the Council on the results of the third meeting of the Group.

1721st plenary meeting
30 July 1970

ANNEX II

LIST OF DOCUMENTS

<u>Document No.</u>	<u>Agenda item</u>	<u>Title</u>
ST/SG/AC.8/R.6/Add.2	1	Royalties (leasing, film rentals, copyright royalties): the scope of royalties
ST/SG/AC.8/R.29	2	Dividends: Tax treatment of dividends
ST/SG/AC.8/R.40	4	Application of tax-sparing provisions under statutes or treaties of various countries
ST/SG/AC.8/R.39 and Corr.1 (E only)	4	Tax sparing and alternate measures in Sri Lanka
ST/SG/AC.8/R.41	3	Exchanges of information for the prevention of international tax evasion and avoidance
ST/SG/AC.8/R.37	3	International tax evasion and avoidance in Ghana
ST/SG/AC.8/R.38	3	Exchange of information submitted by the member from India
ST/SG/AC.8/R.35	3	Tax evasion in Mexico
ST/SG/AC.8/R.6/Add.8	5	Non-discrimination
ST/SG/AC.8/R.36	5	An analysis of taxation of mineral resources in developing countries (mining royalties and other fiscal measures)

ANNEX III

ALTERNATIVE DRAFT TO ARTICLE OF THE OECD DRAFT DOUBLE TAXATION
CONVENTION AND SUGGESTIONS BY MEMBERS OF THE AD HOC GROUP OF
EXPERTS: OBSERVATIONS ON CAPITAL GAINS AND DIVIDENDS* a/

Article 13

Capital gains

Additional paragraph 4 proposed by the member from the Philippines

4. Gains from the alienation of shares of stock in a corporation, securities, bonds or debentures or any other certificate of indebtedness may be taxed in the place where the issuing corporation or entity is created, organized or incorporated.

Explanation

There should be a special provision regarding the gains derived from the alienation of shares of stock, securities, bonds, debentures and other certificates of indebtedness. These are peculiar holdings of a person and complicated ones. There are doubts as to whether the certificates of shares of stock or of the indebtedness is the property itself. We believe that the certificates are merely the evidence of ownership or participation in a corporation. The equity of the shareholder is in the assets of the corporation. Therefore, the country where the corporation is organized or incorporated must have the right to tax the gains derived from the alienation of the shares of stock. The source of the income is the country which is the situs of the corporation.

It is also proposed to redraft paragraph 3 as follows:

3. Gains from the alienation of any property other than those mentioned in paragraphs 1, 2 and 4 may be taxed in the Contracting State where the property is located.

Explanation

This is a catch-all provision which totally deprives the country where the property is located of its taxing rights. There is no sound reason why this should be treated differently from that of immovable property. The country where

* Submitted by the member from the Philippines.

a/ Organisation for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital (Paris, 1963), p. 49.

the property is located has the obligation of protecting it. Why should it be deprived of taxing the gains derived therefrom? If it has an obligation, it must have a right to tax gains.

Article 13

Capital gains

(Alienation of property)

1. Gains from the alienation of immovable or real property, as defined in article 6, paragraph 2, may be taxed in the Contracting State in which such property is situated.

2. Gains from the alienation of property, other than immovable or real property, forming part of the business property of a permanent establishment which an enterprise of one of the Contracting States has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise), may be taxed in that other Contracting State. However, gains derived by a resident or a corporation of one of the Contracting States from the alienation of ships or aircraft operated in international traffic and property, other than immovable or real property, pertaining to the operation of such ships or aircraft, shall be exempt from tax of the other Contracting State.

3. Gains from the alienation of shares in a corporation or securities, bonds or debentures and other certificates of indebtedness may be taxed in the place where the issuing corporation is created, organized or incorporated.

4. Gains derived by a resident or corporation of one of the Contracting States in the other Contracting State from sale, transfer or conveyance of any property, other than those mentioned in paragraphs 1, 2 and 3, may be taxed in the Contracting State where the property is located.

Article 10

Dividends

Alternate proposal to paragraph 2 (in case the rates are to be limited)

2. However, the tax so charged in the Contracting State where the company paying the dividend is a resident shall not exceed:

(a) 10 per cent of the gross amount of the dividends, if the recipient is a company (excluding partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

(b) In all other cases, 20 per cent of the gross amount of the dividends.

Article 10

Dividends

Alternate draft to article 10 ("Dividends") proposed by member from the Philippines

1. Dividends paid to the resident of a Contracting State by a company which is a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may be taxed in the Contracting State where the recipient of the dividend is a resident and according to the law of that State, but a tax credit should be allowed for the tax paid in the other State (may be removed by virtue of art. 23 B).

3. The provisions of paragraphs 1 and 2 shall not affect the taxation of the corporation in respect of the profits out of which the dividends are paid.

4. The term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident (same as OECD, para. 3).

5. The provisions of paragraphs 1 and 2 shall not apply if the recipient of the dividends, being the resident of a Contracting State, has in the other Contracting State, of which the company paying the dividends is a resident, a permanent establishment with which the holding by virtue of which the dividends are paid is effectively connected. In such a case, the provisions of article 7 shall apply (same as OECD, para. 4).

6. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company to persons who are not residents of that other State, or subject the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State (same as OECD, para. 5).

Justification

The proposal seeks to establish the primary right of the source country to tax income arising therein, in contradiction to the present provisions of article 10, which grant the primary right to the home country to tax dividends arising in one country. The developing country takes a very strong position of adopting the principle that the country of source of income should have the primary right to tax such income without curtailment of its taxing rights.

It must be pointed out that one of the provisions of the OECD model draft which is unacceptable to the developing countries to enter into a tax treaty is the present provision under article 10. In fact, of the 22 tax treaties negotiated between developing and developed countries for the years 1963 to 1967, only

one country signed in accordance with article 10 of the OECD draft, and this country may no longer be considered as developing. We need not stress any further the arguments advanced for and in behalf of the residence rule or the source rule. Much has been written and said on this matter which needs no further elucidation. The permanent establishment rule fortifies the position of the developing country in its primary right to tax income arising therein by providing that only so much of the profit attributable to the permanent establishment may be taxed by the State where the permanent establishment is located, thus giving full right of taxation to the country of source.

Long before tax treaties were entered into, the primary right of the source country to tax dividend income arising therein has been acknowledged by many developed countries through provision in their tax systems of the tax-credit method for foreign source income. In earlier days, the right of all countries to tax income and business activity conducted within their countries was universally recognized, being an attribute of sovereignty. It was only in more recent years, when means of transportation and communication were well developed, facilitating more international business transactions that the question of tax jurisdiction and elimination of double taxation came about. A study was therefore started even by the League of Nations, which brought about the Mexico and London drafts.

The OECD countries, much concerned with the problem of double taxation and a desire to eliminate tax barriers to international trade, issued the OECD Model Draft Convention in 1963, with provisions deemed suitable among themselves. They were, however, observed mainly by countries whose economic levels were approximately the same and which belonged to the same geographical areas. Very few, if any, of the less developed countries participated in drafting this model tax convention.

The provisions of the model draft, especially those on dividends, interests and royalties, may be acceptable among developed countries whose economic levels are almost the same, because whatever taxes they forgo on income arising in their country by foreigners could be recouped in the full taxation of their residents. This is the first time that less developed countries are really given a chance to express their opinion and participate in drafting provisions which will be suitable to them when entering into tax treaties with developed countries.

No matter what guidelines are adopted by the present Tax Expert Group, there will always be reluctance on the part of the developing countries to enter into any tax treaty where their taxing rights on dividend income arising from their country will be curtailed or diminished. If we are to achieve the purpose for which this ad hoc Group of Tax Experts was called upon, that is, to explore ways and means to facilitate the conclusion of tax treaties between developed and developing countries, the primacy of the principle of source rule instead of the residence rule must be recognized.

It has been suspected that the non-conclusion of tax treaties between developed and developing countries impedes the free flow of capital from the developed to the developing countries and that, in order to accelerate the flow of capital, the developed countries argue that the rates of withholding tax on dividends by the developing countries be reduced to a range of from 5 to 15 per cent. It is assumed that by reducing the withholding tax on dividends by the developing countries, there will be more attraction for capital to flow in.

In order that tax concessions may really create incentives for capital to come in, the tax waived must inure to the benefit of the investor. Mere reduction of the withholding tax on dividends by the developing countries without a complement of tax exemptions or tax credit with tax sparing on the part of the developed countries would in no way benefit the investor and would only involve a shifting of the payment of part of the tax from the treasury of the developing countries to that of the developed countries. Reduction of the withholding tax on dividends by developing countries is not, therefore, the only alternative to enhance the free flow of capital to them.

Let us abandon the residence rule and recognize the legality and propriety of the source rule. Let the country of source of income assert its full taxing right and the country of residence exempt it. This is the best approach to the double taxation problem. After all, levying one tax on the same income is not objectionable. Tax is always considered a necessary business expense, and all businessmen are always ready and willing to pay it!

Let tax incentives to invite foreign capital be left to the national laws of developing countries. This is a wiser policy because the tax incentive laws can be directed along the areas requiring economic development in the country. In fact, many developing countries have adopted incentive laws to invite the flow of capital, which are much broader in scope than mere reduction of withholding-tax rates.

It has been argued by developed countries that revenues should be shared between the capital-exporting country and the country of source of income. Why should developed countries crave to share with the meager revenues of the poor country? Why can't the developed country allow in full the collection of tax by the developing country? It is a trend in the modern world for the developed countries to extend aid to the developing countries in order to raise their economic development and standard of living that may approximate the level of the developed countries. The United Nations has greatly concerned itself with narrowing the gap between the rich and poor countries in order to achieve a better world. How can this world aspiration be accomplished if the revenues of impoverished countries will still be shared between the haves and the have-nots?

It is also argued that withholding-tax rates which are too high may discourage the flow of capital. While it may be admitted that tax is a factor to be considered in investment, it is only a very minor one. The optimum consideration for an investor to engage in business is "profitability", assuming that all other factors such as stability of government, peace and order, facilities and other governmental policies are normal. Payment of taxes is not so material as long as the net return after taxes is fair and reasonable. Most developing countries, because of the availability of cheap raw materials, low cost of labour, low cost of living and potentiality of good markets, offer good opportunities for profit, which is the real attraction for capital to come in. The developing countries have this much to offer, which is sufficient to attract foreign capital. These factors are the primary considerations for investment, far outweighing tax concessions. Capital has a natural tendency to move to greener fields where it has an opportunity to grow. Capital, like hunger, will always seek a place where it can satisfy its hunger. It is therefore incorrect to argue that the high withholding tax on dividends levied by developing countries impedes the flow of capital.

It is argued that if the level of taxes of the less developed country will exceed that of the taxes imposed by the home country, capital will not move to the less developed country. This may not be true. As pointed out earlier, capital will go anywhere where it will bring the best net return. Profitability is the main consideration for investment. If the net yield of the investment is still high after taxes, the flow of capital will not be discouraged.

Part Two

ISSUES RELATING TO TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Report of the Secretary-General to the Ad Hoc Group of Experts

In pursuance of Economic and Social Council resolution 1541 (XLIX), the Secretary-General prepared a series of studies to assist the Ad Hoc Group of Experts at its 4th meeting. These included detailed reviews of such matters as tax treatment of dividends, exchange of information for the prevention of international tax evasion and avoidance with reference to case studies in a few developing countries such as India, Mexico and Ghana, and methods of elimination of double taxation including tax sparing and alternative measures. Questionnaires on aspects of the tax-sparing credit and exchange of information were sent to the Group of Experts, who availed themselves of the studies to initiate their discussions and suggested that further studies be made in other areas.

I. TAX TREATMENT OF DIVIDENDS*

A. Statutory law of selected developed countries

Dividends received by non-corporate shareholders

Every tax system must, in one form or another, take a position on the problem of economic double taxation of corporate profits, i.e. the fact that these profits are first taxed to the corporation as and when they are earned, and again to the shareholders as and when they are distributed to them as a dividend. Depending on their approach to this problem, developed countries can be roughly divided into four groups. A number of countries, while fully aware of the problem, have decided not to give any relief on that ground. Other countries give relief from double taxation at the corporate level, and a third group provides relief at the shareholder level. Finally, certain countries have devised particular methods of relief that are not applied elsewhere.

Countries not extending any relief

Countries that have made a policy decision to accept the unrestricted double taxation of distributed corporate profits include, among others, Denmark, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom of Great Britain and Northern Ireland. Where both the corporation and the shareholders pay tax at the rate of 50 per cent, the aggregate corporate and individual taxes on the distributed profits amount to 75 per cent; where the corporation is taxed at the rate of 50 per cent and the shareholder at a marginal rate of 60 per cent, the combined tax burden is 80 per cent.

Countries extending relief at the company level

Relief from double taxation at the company level means that distributed profits of a corporation are taxed at a lower rate than its retained earnings. This system applies at present in Austria, the Federal Republic of Germany, Greece, Japan and Norway. Belgium might also be included in this category, although the tax benefit extended to distributed profits is very slight. Since the relief measure is applied to the corporate tax, it benefits non-resident as well as resident shareholders.

Under the law of Austria, distributed profits are taxed at one half the rates (between 31 and 57 per cent) that apply to retained earnings. Since the amount of profits that must be retained to pay the tax on distributed profits is

* In the preparation of this chapter, the United Nations Secretariat was assisted by Henry J. Gumpel, Attorney-at-Law, Walter, Conston, Schurtman and Gumpel, p.c., New York, who acted as a consultant.

itself an item of undistributed profits that is taxed at the higher rate, the effective aggregate minimum rate will always be higher than the statutory rate of 20 per cent. Assuming, for example, that the median tax rate on retained earnings is 40 per cent and that all profits after payment of income taxes are distributed, the aggregate tax rate would be 25 per cent. 1/

A similar system applies in the Federal Republic of Germany. Disregarding the 3 per cent income tax surcharge presently in effect, the statutory rates applying to distributed profits and retained earnings are 15 and 51 per cent, respectively. For the reasons indicated above, the minimum effective tax rate which applies after all after-tax profits are distributed is 23.85 per cent (not 15 per cent). The system briefly summarized here may be replaced by an entirely different one that would provide far-reaching relief at the shareholder level.

The basic corporate tax rate in Greece is 35 per cent, increased by a 15 per cent surcharge. Since the surcharge is deductible in computing taxable income, the aggregate tax rate is slightly over 38 per cent. This rate applies to retained earnings only. Dividends are deducted in computing taxable income so that the tax on distributed profits is zero. The tax on retained earnings is refunded to the corporation if these earnings are distributed at a later time. Accordingly, distributed profits are taxable only in the hands of the shareholders.

A similar rule applies in Norway. The corporate taxes imposed in that country are a State tax at the rate of 26.5 per cent and a municipal tax which varies between 17 and 20 per cent; the latter rate is the prevalent one. For State tax purposes, a corporation is entitled to deduct the amount of distributed profits so that in principle only retained earnings (including required appropriations to the statutory reserve) are subject to the tax. Distributed profits are subject to State tax at the shareholder level. As a result, the corporation is taxed at a rate of approximately 50 per cent on retained earnings and 23.5 per cent on distributed profits in cases of a full distribution.

A split-rate system also applies in Japan. Retained earnings are presently taxed at a combined maximum rate (corporation tax, inhabitants tax and

1/ The formula for computing the amount of minimum undistributed profits (or minimum tax) is:

- y = taxable income for corporation income tax purposes
- x = profits to be retained for payment of tax
- 0.40 = tax rate on retained earnings
- 0.20 = tax rate on distributed profits

Then:

$$\underline{x} = 0.40\underline{x} + 0.20 (y - \underline{x})$$

If profits are 1,000, the formula becomes

$$\underline{x} = 0.40\underline{x} + 0.20 (1,000 - \underline{x})$$

$$\underline{x} = 250$$

Tax on retained earnings (40 per cent of 250)	100
Tax on distributed profits (20 per cent of 750 (1,000 - 250))	150
Total tax	250

enterprise tax) of 48.35 per cent, and distributed profits at a maximum rate of 36.02 per cent.

Countries extending relief at the shareholder level

Under the tax systems of Belgium and France, corporate taxes are treated as paid in part on behalf of the shareholders, who therefore receive a credit against their individual income tax. A similar system may be introduced in the Federal Republic of Germany. Canada also provides a credit against an individual shareholder's tax for a fixed percentage of the dividends received; the amount of this credit has been considerably enlarged by the recent reform bill.

Belgium provides a fixed credit (crédit d'impôt) of 15 per cent (one-half of the regular corporate tax rate) against the shareholder's tax on dividends. The shareholder includes 85/70 of the gross dividend in taxable income and reduces the tax payable thereon by two credits amounting to 15/70 (one-half of the corporate income tax of 30 per cent) and 14/70 (withholding tax at the rate of 20 per cent). The shareholder can claim a refund if the withholding tax exceeds the income tax due; however, the credit for one-half of the corporate tax never results in a refund.

A much more elaborate, and from the shareholder's viewpoint more advantageous, system applies in France. An individual shareholder receives, irrespective of the relative size of his investment, a tax credit (avoir fiscal) of 50 per cent of the gross amount of the dividend, provided that the profits from which the dividend is paid have borne French corporate income tax at the full rate of 50 per cent. The following example illustrates the effect of these rules.

Example 1

Pre-tax profit of corporation	100
Corporate tax, at 50 per cent	<u>50</u>
Balance distributed as dividend	50
Tax credit	<u>25</u>
Dividend reported by shareholder	<u>75</u>
Shareholder's income tax at average rate of 50 per cent	37.5
Tax credit	<u>25</u>
Balance of tax payable	<u>12.5</u>

If the shareholder's individual income tax applying to the dividend income is less than 37.5 per cent, the difference is refunded.

The rule is modified if the corporate profits from which the dividend is paid have not borne French corporation tax at the full rate, e.g. because the profits were earned abroad. To the extent that the profits were not fully taxed, a corporation distributing a dividend is required to make a prepayment (précompte) in the amount of the tax credit to the French Government. The following example illustrates the computation.

Example 2

Pre-tax profit of corporation:

From French sources	200	
From foreign sources (after foreign tax) .		300
French income tax, at 50 per cent	100	
Prepayment (<u>précompte</u>) equal to		
tax credit	<u>-</u>	<u>100</u>
	100	200
		300
Tax credit (one-half of French income		
tax plus entire amount of prepayment) . . .	<u>150</u>	
Dividend income	<u>450</u>	
Individual income tax, at 50 per cent . . .	225	
Tax credit	<u>150</u>	
Tax payable on dividend	<u>75</u>	
Dividend income	<u>450</u>	
Individual income tax, at 30 per cent . . .	135	
Tax credit	<u>150</u>	
Refund	<u>15</u>	

The Tax Reform Commission appointed by the German Government in 1968 recommended the substitution of a tax credit system after the French model for the split rate system as of 1 January 1974. The proposed system would be even more favourable to the shareholder than the French system because credit would be granted for the full amount of the corporate tax. It is presently planned to set the uniform corporate tax rate at 56 per cent. This figure would also become the maximum rate of the individual income tax, although somewhat higher figures have also been named. The Commission's Report points out that tax considerations will no longer be a factor in selecting the legal form of an enterprise because all business enterprises will be taxed alike. The Report also states that there would no longer be a need for dividend withholding taxes under the proposed system and that the tax advantages presently enjoyed by non-resident shareholders would be terminated.

Under existing Canadian law, which, however, is about to be changed, a resident shareholder of a Canadian corporation can reduce his tax by 20 per cent of the dividend income. The Tax Reform Bill, which the Canadian Government submitted to Parliament on 18 June 1971, increases the rate of the credit to 33 1/3 per cent; it also requires the shareholder to include this credit in income. It is claimed that the proposed change would make the dividend credit more equitable and reduce the tax burden of individuals whose marginal income tax rate is less than 40 per cent.

Intercompany dividends

Domestic intercompany dividends

Practically all developed countries grant tax relief for dividends distributed by one member of an affiliated group of corporations to another member because the conduct of a unitary business through various corporate vehicles does not justify multiple taxation of the same profits. A number of countries extend this relief to other corporate dividends regardless of the proportional size of the investment.

United States of America

American tax law provides for a 100 per cent dividends received deduction for dividends passing between members of an affiliated group of corporations. The same relief is available to so-called small business investment companies. In all other cases, the dividends-received deduction amounts to 85 per cent of domestic dividends.

United Kingdom of Great Britain and Northern Ireland

Dividends which one company resident in the United Kingdom receives from another resident company are referred to as "franked investment income" and are not chargeable to corporation tax in the hands of the recipient corporation. Such dividends are, however, subject to withholding of income tax at the standard rate. The income tax deducted from the dividend can be used by the recipient company as a set-off against the income tax which the company is required to account for under schedule F on its own distributions. The income tax on dividends received will support a claim for refund if it is offset by trading losses of the recipient company. If a corporation has an excess of franked investment income over the amount of its distributions for any year, this excess may be carried forward and set off against the tax in future distributions. Failure to withhold tax results in the payment is regarded as a net amount remaining after the deduction of tax from a corresponding gross amount.

France

The rules of taxation differ for French corporations which qualify as "parent companies" and others which do not so qualify.

To qualify as a parent, a company must be incorporated in France and hold shares representing at least 10 per cent of the issued capital of the "subsidiary". The shares must be nominee, or, if in bearer form, be deposited with an approved financial establishment. The shares must have been subscribed for at time of issue or the company must have committed itself to hold them for at least two years from time of issue. The subsidiary may be a French or a foreign company.

If the recipient company qualifies as a parent, the dividend it receives from the subsidiary, less its expenses related to the dividend income, is excluded from taxable income. The expenses related to the income are arbitrarily fixed at 5 per cent of the dividend plus one-half of the tax credit that attaches

to it. The tax credit amounts to 50 per cent of the dividend distributed by a French company. If the subsidiary is a French corporation, taxable dividend income thus amounts to 7.5 per cent of the gross dividend. In the case of dividends received from a foreign subsidiary, the credit may be equal to the foreign withholding tax as determined under the rules of a tax convention.

A company which does not qualify as a parent includes the dividend in taxable income and deducts one-half of the tax credit attached to the dividend from its income tax. As stated before, the tax credit amounts to 50 per cent of a domestic dividend. For dividends distributed by foreign corporations there may or may not be a credit for foreign withholding taxes, depending on the provisions of a tax convention between France and the foreign country.

The rules stated above may be illustrated as follows:

<u>Recipient entity</u>	<u>French parent</u>	<u>French company not qualifying as parent</u>
Dividend declared by French company	100	100
<u>Less:</u> Withholding tax	<u>-</u>	<u>-</u>
Net dividend received	100	100
Tax credit	<u>50</u>	<u>50</u>
Amount subject to corporation income tax	<u>7.5</u>	<u>7.5</u>
Corporation income tax at 50 per cent .	3.75	50
<u>Less:</u> Deduction of one-half of the tax credit	<u>-</u>	<u>25</u>
Net tax payable	<u>3.75</u>	<u>25</u>
Net dividend retained	<u>96.25</u>	<u>75</u>

Federal Republic of Germany

If a German resident corporation or other commercial entity invests in another resident commercial entity, the dividends distributed by the latter are not subject to corporation income tax, provided that the recipient entity has held 25 per cent or more of the share capital of the subsidiary directly and continuously for at least 12 months prior to the end of its taxable year in which it receives the distribution. This intercompany dividend exclusion does not apply to distributions by foreign subsidiaries as a matter of statutory law; it has been extended to such distributions, however, under most recent tax conventions of the Federal Republic.

A domestic subsidiary is not obliged to withhold tax at the source upon payment of a dividend to its parent company; accordingly, the dividends are

burdened only with the 15 per cent corporate tax on distributed profits paid by the subsidiary. However, the exemption of the distribution in the hands of the parent requires that the latter redistribute the dividend received to its own shareholders. If this rule is not observed, the dividend becomes subject to a "supplementary tax" at the rate of 36 per cent, which, together with the 15 per cent tax paid by the subsidiary, raises the aggregate tax rate to 51 per cent, the tax rate applicable to retained earnings. There is a conclusive statutory presumption that the recipient corporation distributes its own profits before redistributing the dividend received to its shareholders. Accordingly, the conditions for utilizing the intercompany dividend exclusion are difficult to meet unless the recipient entity is a pure holding company.

Japan

Dividends and deemed dividends received from domestic corporations are excluded from gross income. Interest applicable to the acquisition cost of the shares is not deductible.

The Netherlands

A Dutch corporation is not taxed on dividends (in cash or property) it receives from another Dutch corporation if the following conditions are satisfied. The participation in the distributing corporation must amount to at least 5 per cent of the par value of the paid-up capital of the company in which the investment is made; the shares must have been held continuously from the beginning of the recipient company's taxable year; and the parent must not be an investment company. Investment companies, which may hold real estate and mortgages in addition to securities, are also exempt from corporation income tax on dividends received by them, provided they distribute their net income currently to the shareholders.

Switzerland

Dividends received are exempt under federal law and the law of 13 cantons if the recipient corporation owns at least 20 per cent of Sw. F 2 million in value of the capital of the distributing corporation. The latter may be a Swiss or a foreign entity.

Norway

Domestic intercompany dividends were exempt from Norwegian taxes on income (State and municipal taxes) until 1970. Dividends received after the end of that year are subject to State but not municipal tax.

Sweden

As a general rule, a Swedish corporation is exempt from corporation income tax with respect to dividends received from another Swedish corporation in which it holds a participation of at least 25 per cent in terms of voting power.

Smaller participations may qualify if the holding is connected with the shareholder's business or that of a related company; portfolio holdings never qualify. These rules do not apply to dividends collected by banks, investment companies, holding companies and closely held corporations which fail to redistribute the dividends received (or a major portion thereof in the case of investment companies) to their own shareholders.

Belgium

A Belgian corporation deducts 95 per cent of the net dividends received from another Belgian corporation and pays tax on 5 per cent of the dividend to the extent that the tax rate of the recipient corporation does not exceed 30 per cent. The deduction is reduced to 90 per cent for portfolio holding companies. In either case, the exemptions apply irrespective of the relative size of the investment. The exemptions apply to the net amount received after Belgian and foreign withholding taxes.

Intercompany dividends derived from foreign corporations
or paid to non-resident shareholders

United States of America

As a **general** rule, intercompany dividends derived from a foreign corporation are fully taxable in the hands of a United States corporate shareholder. The dividends received deduction applies, to a limited extent, to distributions made by foreign corporations that have been engaged in trade or business in the United States for a consecutive period of 36 months (or such shorter period as the foreign corporation has been in existence), provided that at least 50 per cent of its gross income from all sources during that period has been effectively connected with the conduct of a trade or business in the United States. If these conditions are satisfied, the dividends received deduction can be claimed for that proportion of the distribution which corresponds to the ratio between the corporation's gross income that is effectively connected with its United States business to total gross income (Internal Revenue Code, Title 26, sect. 245).

Apart from the foregoing, a United States corporation can claim the "direct" foreign tax credit (Internal Revenue Code, Title 26, sect. 901) for foreign withholding taxes imposed on the dividend and the "indirect" or "deemed paid" foreign tax credit under section 902 of the Code for underlying taxes of the foreign corporation. This credit can be claimed to the extent that dividends are distributed by the first, second or third-tier foreign subsidiary, provided that the shareholdings at each level amount to at least 10 per cent in terms of voting power, with an over-all minimum shareholding of not less than 5 per cent (Internal Revenue Code, Title 26, sect. 902, as amended in 1970).

In the absence of a tax treaty, dividends paid to a foreign corporation are subject to withholding tax at the rate of 30 per cent (Internal Revenue Code, Title 26, sect. 1441).

United Kingdom of Great Britain and Northern Ireland

Intercompany dividends received from a foreign corporation are subject to corporate tax, presently at the rate of 40 per cent. The foreign tax credit (direct and indirect credit) applies. Unlike the rule in the United States, there are no limitations on the indirect foreign tax credit concerning a minimum investment in foreign corporations or the number of tiers of ownership of foreign subsidiaries.

The statutory withholding rate for dividends is the income tax, presently at the rate of 38.75 per cent.

France

No distinction is made under French law between domestic and foreign intercompany dividends. Thus, the statements made in reference to domestic intercompany dividends apply in full to distributions made by foreign subsidiaries of French companies.

Federal Republic of Germany

As a matter of statutory law, foreign intercompany dividends are as a rule fully subject to German corporation income tax; the intercompany dividend exemption in favour of domestic dividends does not apply. Present German tax law recognizes only the direct foreign tax credit for foreign withholding taxes paid, but not an indirect credit for the underlying tax of a foreign subsidiary which distributes a dividend. 2/

In lieu of claiming the foreign tax credit, a resident corporate shareholder of a foreign corporation engaged in certain active business operations and located in a non-treaty country can elect to be taxed on the dividends at the flat rate of 25 per cent, provided that the investment amounts to at least 25 per cent of the share capital of the foreign corporation and that it was held by the resident entity continuously from the beginning of its taxable year.

The statutory withholding rate on dividends distributed to foreign corporations is 25 per cent.

2/ As the first exception to this rule, a bill designed to combat tax evasion in international transactions presently before the parliamentary committees provides for a deemed-paid foreign tax credit for foreign income taxes imposed on base company income of controlled foreign corporations. Unlike the United States rule, this credit can be claimed by individuals as well as corporations and is not dependent on the distribution of a dividend.

Japan

Foreign intercompany dividends are in principle fully taxable, subject to the direct foreign tax credit, and, if certain conditions are met, a deemed paid foreign tax credit. The latter credit can be claimed if the Japanese corporation owns no less than 25 per cent of the issued share capital of the foreign corporation in terms of number of shares or voting power, and if the foreign corporation has been established for the purpose of carrying on a bona fide business in the foreign country and not merely for tax reasons. The deemed paid credit can be claimed in proportion to the amount of dividends distributed by the foreign corporation.

The statutory withholding rate on dividends is 20 per cent.

The Netherlands

A Netherlands corporation is not taxable with respect to dividends received from a foreign corporation, provided that it holds at least 5 per cent of the latter's paid-in share capital and that the foreign corporation is subject to a national tax on income or profits at its domicile. The rate of the foreign tax and the method of computing the taxable income of the foreign corporation are of no importance. Another condition is that the shares of the foreign corporation are not held for investment purposes only.

In addition to the general holding privilege just discussed, which applies to all Netherlands corporations, a special tax régime is extended to open-end or closed investment companies. These companies may invest in real property and mortgages in addition to securities and are exempt from Netherlands tax provided they distribute their entire ordinary income (as distinguished from capital gains) to their shareholders.

Switzerland

Foreign intercompany dividends, as domestic dividends, are in principle subject to a Swiss federal income tax (defence tax). An exception applies, however, if the Swiss corporation owns at least 20 per cent of the stock of the foreign corporation or Sw. F 2 million in value thereof. Such dividends are included in taxable income, but the tax of the company is reduced in the proportion which dividends received from the "substantial participation" bear to gross income. It follows that a pure holding company whose income consists exclusively of dividends is entirely exempt from federal income tax. The same rule applies in 13 (out of 25) cantons.

The statutory withholding rate on dividends paid to foreign shareholders is 30 per cent.

Norway

The general statutory rule in Norway is that foreign income received by Norwegian companies is fully subject to state and local income taxes, except that foreign withholding taxes are permitted as a deduction from income. However, only 50 per cent of income from foreign real property or profits of a foreign permanent establishment are subject to Norwegian tax. This 50 per cent

exemption also applies to foreign dividends collected through a foreign permanent establishment or those received directly if the Norwegian company, either alone or together with not more than nine other residents of Norway, owns at least 95 per cent of the shares of the foreign corporation and the latter in turn owns real property or business establishments situated outside Norway.

The Norwegian statutory withholding rate on dividends paid to foreign shareholders is 25 per cent.

Sweden

Foreign intercompany dividends are subject to the same rules of taxation as those which apply to domestic intercompany dividends.

The statutory withholding rate on dividends paid to foreign shareholders is 30 per cent.

Belgium

Intercompany dividends received from foreign sources are subject to the précompte mobilier (tax prepayment) of 10 per cent, computed on the net amount of the dividend after foreign withholding tax. The 95 or 95 per cent deductions discussed in connexion with domestic dividends can be claimed for the net amount of the foreign dividend after deduction of the précompte mobilier and foreign taxes applicable to the dividend.

The statutory rate of withholding tax on dividends paid to foreign shareholders is 20 per cent.

Canada

Under present law a Canadian company can exclude dividends received from a foreign corporation if it owns more than 25 per cent of the latter's voting stock.

The foregoing rule has been substantially changed by the Tax Reform Bill which is in the process of becoming law. The Tax Reform Act became effective on 1 January 1972.

Under the Bill the exemption of dividends received from non-resident corporations in which a Canadian company holds a substantial interest will be continued with respect to distributions made from profits earned prior to 1976. Distributions from profits of 1976 and later years remain exempt if the profits were earned in a country with which Canada has a tax treaty. The extent to which dividends from subsidiaries of non-treaty countries are taxed will depend on the amount of foreign taxes, including withholding taxes paid by the foreign affiliate. The Canadian tax on these dividends shall be the amount required to bring the total burden of domestic and foreign taxes up to the level of the Canadian corporate tax. The rate of this tax will remain at 50 per cent until the end of 1972; from then on, it will be reduced by one percentage point each year until 1976, when it reaches 46 per cent.

Unless the Canadian Government should be successful in concluding a significant number of tax treaties with foreign countries by the end of 1975 (see White Paper), the new rule appears to discriminate against developing countries with moderate tax rates.

The rate of the Canadian withholding tax on dividends (presently 15 per cent) is to be increased to 25 per cent. In the case of companies with a "degree of Canadian ownership", the present withholding rate of 10 per cent is to be increased to 20 per cent.

B. Statutory law of selected developing countries

Intercompany Dividends Paid to Foreign Corporations

Argentina

Argentine corporations and partnerships limited by shares as well as associations of the civil law are subject to corporation tax on their **net** taxable income at the flat rate of 33 per cent. No difference is made between distributed profits and retained earnings. Withholding tax at the rate of 12 per cent is payable on dividends paid to non-residents, without distinction regarding the characteristics of the non-resident shareholder. The withholding tax does not apply to stock dividends.

Brazil

The general rate of the corporation tax is 30 per cent; distributed profits are subject to an additional corporate income tax at the rate of 5 per cent except for distributions made by certain noncommercial entities, distributions of stock dividends resulting from the capitalization of reserves or surplus and dividends paid by companies with limited capital and reserves, as defined from time to time by statute and in a few other situations.

The general rate of the dividend withholding is 25 per cent. However, distributions made to non-residents which exceed 12 per cent of the average registered capital of the corporation during a three-year period (beginning in 1963), are taxed at the following rates computed on the excess amount:

Between 12 and 15 per cent	40 per cent
Between 15 and 20 per cent	50 per cent
Over 25 per cent	60 per cent

Chile

Corporations engaged in commerce, industry, mining or fishing are taxed at the rate of 35 per cent. No distinction is made between distributed and undistributed profits. Except for stock dividends and certain other distributions, dividends paid to non-resident shareholders are subject to withholding tax at the

rate of 37.5 per cent. In addition non-resident shareholders may become liable for a special 7.5 per cent tax on their participation in the profit of the corporation regardless of actual distributions made. The basis of this tax is the net profit approved by the annual shareholders' meeting, reduced by additions to the legal reserve and interim dividends paid during the year. This tax does not apply to shareholders who submit an affidavit that they in fact own the stock that is registered in their name or who, if the shares are held by them in trust, disclose the identity of the beneficial owner.

Ghana

The company income tax of Ghana applies to all income accruing in, derived from, brought into or received in the country. The rates of the tax are 55 per cent for income retained in the country and 62.5 per cent for income transferred abroad. For companies registered under the Excise Ordinance of 1953, the corresponding rates are 50 and 57.5 per cent. The higher rates thus apply to profits distributed as dividends to non-resident shareholders. The tax is deducted from the dividend and accounted for by the Ghanaian corporation, and no further dividend tax is payable by the shareholder.

India

Caveat: The tax rates shown below are those for the fiscal year 1970/1971. As a result of the general election held in March 1971, the budget proposals of the Government were not presented to Parliament until late in May, and the Finance Bill for the 1971/1972 fiscal year was not enacted at the time of this writing.

Domestic companies: An Indian company in which the public is substantially interested (a so-called section 108 company) 3/ pays income tax at the rate of 55 per cent, or 45 per cent of its taxable income is less than Rs 50,000. Other Indian companies pay income tax at the rate of 65 per cent, except for companies engaged in preferred industrial activities including the generation or distribution of energy, shipbuilding, mining or the manufacturing or processing of goods. An Indian company at least 51 per cent of whose taxable income is derived from such qualifying activities is taxed at the rate of 55 per cent on the first Rs 1,000,000 of taxable income, and 60 per cent on the balance. Long-term capital gains (gains from the disposition of assets held for more than two years) are taxed at the rate of 40 per cent if derived from the sale of real property, and 30 per cent in other cases. In addition, every company is liable for surtax. This tax is assessed at the rate of 25 per cent on the excess of its "chargeable profits" 4/ over 10 per cent of its capital 5/ or Rs 200,000, whichever is greater.

3/ In broad outline, this is the case if either (a) not less than 40 per cent of the shares of the company are owned by the Government; or (b) if the company is not a private company as defined in the Companies Act, 1956, and several other alternative requirements are complied with.

4/ Chargeable profits means, in general, taxable income after certain adjustments.

5/ Including paid-up share capital, certain reserves and certain types of borrowed capital.

Dividends which an Indian company receives from abroad are taxed as **ordinary** business income. The same applies to domestic dividends, except that only 40 per cent of the dividend is included in taxable income.

Withholding taxes on dividends are imposed at the rate of 22 per cent on distributions made to an Indian company; 14 per cent on distributions to a foreign company, provided that the distributing corporation is not a section 108 company and that at least 51 per cent of its income is derived from a priority industry; and 24.5 per cent on distributions by other Indian companies.

Where the profits of an Indian company distributed as dividends are less than the statutory percentage of the distributable income, 6/ an undistributed profits tax is levied at the rate of 50 per cent (investment companies), 37 per cent (trading companies) or 25 per cent (other companies) on the distributable income as reduced by the amount of dividends actually distributed. Distributable income consists in the main of total income less income tax and surtax.

A newly established industrial enterprise which satisfies certain conditions is entitled to a deduction of so much of its profits as does not exceed 6 per cent of the capital employed. This tax holiday is granted for the first five years from the commencement of manufacture. Unabsorbed relief may be carried forward up to eight years after the date named, **unless** it arose in a financial year ended on or before 31 March 1966.

Foreign companies: A foreign company engaged in business in India is taxed at the rate of 70 per cent if it is recognized as a company for Indian tax purposes. If such recognition is not obtained, the foreign company is assessed as a non-resident association of persons, at graduated rates of up to 85 per cent (on the balance of taxable income over Rs 200,000), plus a 10 per cent surcharge. Whether or not it is advantageous for a foreign company to obtain recognition depends largely on the nature and amount of its Indian-source income. If the income is regular business income, qualification as a company will **always** be advantageous **unless** the expected profit is minimal.

A foreign company that is recognized as a company is subject to the surtax discussed above. Dividends from Indian sources are subject to the 70 per cent tax rate, but an 80 per cent reduction of taxable income is substituted for the 60 per cent reduction available to Indian corporate shareholders if the Indian company distributing the dividend is a non-section 108 company which derives at least 51 per cent of its income from a priority industry. In other cases, the reduction is 65 per cent.

Royalties and technical service fees which a foreign company receives from Indian sources under Government-approved agreements are taxed at the rate of 50 per cent, on a net basis.

6/ For most companies, the applicable statutory percentage is 60 per cent of the distributable income excluding income derived from the preferred activities discussed in the text. The undistributed profits tax does not apply to certain types of companies, including section 108 companies, Indian companies whose plant and equipment have a book value of more than Rs 5,000,000 and foreign companies.

Israel

An Israeli corporation pays two taxes on income, a company tax of 38 per cent and an income tax at the rate of 25 per cent. The income tax is computed on net profits after deducting the company tax and dividends distributed during the year. Thus, undistributed income is taxed at an effective rate of 53.5 per cent, while distributed income is taxed at a greatly reduced effective rate depending on the relative size of the dividends distributed.

In computing taxable profits for purposes of the company tax, dividends received directly or indirectly from domestic corporations liable for that tax are excluded.

The rate of the dividend withholding tax is 25 per cent.

Mexico

Mexican business enterprises, whether or not organized in corporate form, are taxed at graduated rates of between 5 and 42 per cent. No difference is made between distributed and undistributed profits. An additional income tax (distributable profits tax), which was in effect until 1964, was reintroduced in 1971.

Dividends paid to non-residents of Mexico are taxed at graduated rates of 15 per cent (on the first 180,000 pesos), 17.5 per cent (on the next 90,000 pesos) and 20 per cent (on amounts over 270,000 pesos). After the end of the year, the non-resident corporation should file a return in which the annual dividend income is aggregated and pay the additional tax, if any, on the total dividend income of the year.

Pakistan

Domestic companies: A Pakistani company pays income tax and supertax, both at the rate of 30 per cent. Companies which have made arrangements for the declaration and payment of dividends in Pakistan are entitled to rebates from supertax. Depending on the characteristics of the company and the nature of its income, these rebates vary between 5 and 15 percentage points, thus reducing the supertax by one sixth to one-half. Relief from income tax and supertax is granted at prescribed rates for income from exports.

Beginning with the fiscal year 1971/1972, additional income tax was imposed at the rate of 15 per cent on public companies and 25 per cent on non-public companies that fail to distribute, as a dividend and within 6 months after the close of their business year, at least 60 per cent of the amount of their taxable income less income tax and supertax thereon. The additional tax is imposed on the "excess undistributed income" of the company, as defined in the Income Tax Act.

Domestic intercompany dividends (i.e. cash dividends received from a company having its registered office in Pakistan) are exempt from income tax. Such dividends are also exempt from supertax if received by a parent company having its registered office in one part ("wing") of Pakistan from a subsidiary having

its registered office in the other part of the country. Domestic dividends received by a company in which the public is substantially interested are subject to supertax at the rate of 15 per cent. All other domestic intercompany dividends bear supertax at the rate of 20 per cent. Foreign-source dividends are apparently taxed at the full rates.

Domestic stock dividends are not subject to income tax. They are subject to supertax imposed on the issuing company. The rate of this tax is 15 per cent if the issuing company is a public company, or 20 per cent if it is a non-public company.

Beginning with fiscal year 1971/1972, a surcharge of 10 per cent (in some cases, 12.5 per cent) is added to the income tax and supertax. Including this charge, a public company distributing its entire after-tax profit pays tax at the rate of 60.5 per cent for the current assessment year. Undistributed income is taxed to a public company at an aggregate rate of 77 per cent, and to a private company at the crippling rate of 93.5 per cent.

Foreign companies: A foreign corporation is taxed under the rules applying to domestic companies if it is recognized as a company by the Central Board of Revenue. In the absence of such recognition, the foreign company is taxed as an "association of persons", at graduated rates of up to 70 per cent, plus surcharge. Dividends distributed by Pakistani companies are taxed to a foreign corporation at the same rates as those which apply to other income from sources in Pakistan.

C. Tax treaties

Introduction

As illustrated in the first part of this report, the taxation of corporations and their shareholders poses special problems under the national law of most countries because it becomes necessary to consider at the same time two groups of taxpayers, often with conflicting interests and objectives, and to integrate the rules of taxation applying to both, unless the countries concerned make a conscious policy decision not to relieve the double taxation of corporate profits.

The situation becomes more complicated if the distributing corporation is domiciled in one country and the shareholder is a resident of another country because the rules of taxation applying to the two categories of taxpayer are no longer part of one system.^{7/} Since the corporate tax is not shaped with a view to its effect on the shareholder's tax, the aggregate tax burden on both may be greater than it is on the domestic level in either of the two countries concerned. The situation is aggravated if the country in which the dividend-paying corporation is domiciled levies a corporate tax at a high level and the shareholder's country of residence imposes a substantial individual or corporate income tax without giving statutory relief for foreign taxes on dividends. It is in this area that bilateral tax treaties are called for to provide an equitable solution.

Additional problems arise in the taxation of intercompany dividends. As stated above,^{8/} practically all countries provide relief for such distributions on the domestic level, especially where the corporations that distribute and receive dividends are components of one and the same enterprise. The same would appear to be true, at least from an economic viewpoint, where a parent corporation and its subsidiary are situated in different jurisdictions. In fact, it could be argued that the taxation of parent and subsidiary companies should parallel that of a business enterprise with an unincorporated branch in another country because the question of whether the foreign establishment of a corporation is conducted in corporate or unincorporated form has little economic significance.

The following survey summarizes the kinds of relief that are extended under tax treaties in this area, and the methods through which relief is granted.

Treaties between developed countries

OECD Model Convention

Article 10 of the OECD Model Convention of 1963 provides that dividends shall be taxable in the State of which the shareholder is a resident, but confers a limited concurrent right of taxation on the State in which the distributing

^{7/} "In this matter of dividends, differences between taxation and conflicts of interest have an inhibiting effect that is not apparent in any other part of international fiscal law": Organisation for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital - Report of the Fiscal Committee (Paris, 1963), p. 99, para. 14.

^{8/} See part one (section on domestic intercompany dividends, paras. 57 ff.).

corporation is domiciled. In abrogation of this rule, the provisions of article 7 of the Model Convention, dealing with the taxation of business profits, govern if the shareholding by virtue of which the dividends are paid is effectively connected with a permanent establishment that is maintained in the source country by the recipient of the dividend. 9/

9/ Article 10 of the OECD Model Convention provides as follows:

- "1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the law of that State, but the tax so charged shall not exceed:
 - (a) 5 per cent of the gross amount of the dividends if the recipient is a company (excluding partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
 - (b) in all other cases, 15 per cent of the gross amount of the dividends.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term 'dividends' as used in this Article means income from shares, 'jouissance' shares or 'jouissance' rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State of which the company making the distribution is a resident.
4. The provisions of paragraphs 1 and 2 shall not apply if the recipient of the dividends, being a resident of a Contracting State, has in the other Contracting State, of which the company paying the dividends is a resident, a permanent establishment with which the holding by virtue of which the dividends are paid is effectively connected. In such a case, the provisions of Article 7 shall apply.
5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company to persons who are not residents of that other State, or subject the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."

Distributions other than intercompany dividends 10/

A large number of the conventions surveyed follow the rule of the Model Convention and limit the rate of the withholding tax on dividends other than intercompany dividends to 15 per cent. Treaties in this category include the convention between Austria and Spain (1966); the treaties concluded by Belgium with the Federal Republic of Germany (1967) and Japan (1965), the treaty between Denmark and Japan (1968); the treaties of the Federal Republic of Germany with Japan (1966), 11/ Spain (1966) and the United Kingdom (1964/1970); the treaty between Japan and Norway (1967); the treaties of Luxembourg with the Netherlands (1968) 12/ and the United Kingdom (1967), and the treaty between Spain and Switzerland (1966). In a few instances, different withholding rates are applied by the contracting States. An example in point is the convention between Portugal and the United Kingdom (1968). The rate of the United Kingdom withholding tax under that treaty is 15 per cent, whereas the rates of the Portuguese withholding tax (including additions for substitute inheritance tax and stamp tax etc.) are 17.33 and 26 per cent, depending on whether the shares on which the distribution is made are registered or in bearer form.

Withholding rates higher or lower than 15 per cent are comparatively infrequent. A 10 per cent withholding rate is applied by Austria under its treaty with Ireland (1966). 13/ A 25 per cent withholding tax applies under the convention between the Federal Republic of Germany and Greece (1966), as under all tax treaties concluded by the last-named country, and an 18 per cent rate is stipulated in the Belgium-France convention (1964). 14/

10/ The term "intercompany dividends" is applied here as referring to distributions among corporations or other legal entities of which one holds a substantial participation - as defined in the applicable treaty - in the share capital of the other. Dividends received by a corporation whose investment is less than substantial are only rarely treated differently from dividends paid to noncorporate shareholders under the treaties.

11/ The last-named treaty, as others listed below, makes the reduced withholding taxes inapplicable if the dividends are derived through a permanent establishment in the source country.

12/ Dividends distributed by Luxembourg holding companies are exempt from Luxembourg withholding tax under this treaty.

13/ The Irish tax rate is 35 per cent. However, the tax withheld is the Irish corporation tax, which is recaptured by the corporation upon distribution of the dividend and credited against the tax of the shareholder. It is not a withholding tax in the conventional sense of the term.

14/ Under the (as yet unratified) protocol of 15 February 1971 to the Belgium-France tax treaty, France extends its statutory "avoir fiscal" to Belgian shareholders of French corporations. The nature of this credit is briefly discussed at /Statutory law of selected developed countries - France/.

In addition to the treaties named which distinguish between intercompany dividends and other distributions, a number of conventions apply the 15 per cent withholding tax regardless of the characteristics of the shareholder or the relative size of the investment. Examples of such treaties are those concluded by Belgium with Norway (1967), Sweden (1965/1967) 15/ and the United Kingdom (1967) the treaties of Canada with Ireland (1966), 16/ Japan (1964) and Norway (1966) and the treaty between France and Japan (1964).

Under most of the treaties named, dividends paid on holdings that are attributable to or "effectively connected" with a permanent establishment maintained by a corporation of one of the treaty countries in the territory of the other country are taxed in the latter as part of the industrial or commercial profits of the establishment and not at the statutory or treaty withholding rates. The country in which the corporation is domiciled will recognize the tax of the source country through credit or exemption, depending on the method of treaty relief which it applies. 17/

Without exception, the shareholder's country of domicile applies the foreign tax credit device to preclude the double taxation of dividend income that is subject to withholding of tax in the country of source. In the great majority of cases, this relief is limited to a "direct" credit for the foreign withholding tax, whether or not this relief measure is part of the statutory law of the country. Under some treaties, an "indirect" credit is granted regardless of the proportionate size of the investment in the distributing company. An indirect credit is granted, for example, by Ireland under its treaty with Austria (1966) regardless of the characteristics of the shareholder. In a greater number of treaties, however, this credit can be claimed only by corporate shareholders.

Intercompany dividends

As pointed out earlier, dividend distributions between members of an affiliated group of corporations present special problems on the international as well as the domestic level. In either case, it becomes necessary to prevent the multiple and potentially confiscatory taxation of the same income as long as it is merely shifted from one member of the corporate family to another member without reaching the ultimate beneficiaries outside the group. On the international level, relief from multiple taxation of such income is provided by bilateral tax treaties.

15/ The 15 per cent withholding tax applies under this treaty to Belgian dividends only, while a 5 per cent coupon tax is withheld on Swedish dividends.

16/ Income tax at the rate of 35 per cent is withheld in Ireland. See foot-note 7.

17/ In general, the western European countries exempt profits that are derived through a permanent establishment situated in the other treaty country, while the Anglo-American nations apply the foreign tax credit. Greece is an exception to this rule.

The degree of ownership required to qualify a corporation of one treaty country as the "parent" of a corporation of the other country shows extreme variations (between 10 and 95 per cent). 18/ There are also significant differences in the conditions that must be met to obtain relief, and in the available relief measures.

Subject to the conditions noted below, the relief extended by the source country usually consists in reducing the rate of withholding tax which otherwise applies under the treaty. Thus, a 10 or 5 per cent or zero rate may be substituted for the regular withholding rate under the treaty. A 10 per cent withholding rate applies to both parties to the convention under the treaties between Denmark and Japan (1968) and between Spain and Switzerland (1966), if the recipient company had owned at least 25 per cent of the share capital of the distributing company for a certain minimum period. Under the treaty between Japan and Norway (1967), a 10 per cent withholding rate applies if the recipient entity had owned at least 50 per cent of the voting shares of the distributing entity during the 12-month period immediately preceding the accounting period of the distributing entity for which the distribution was made; a substantially similar provision is included in the treaty between Austria and Spain (1966).

The withholding rate is 5 per cent, on a reciprocal basis, under the treaties of the United Kingdom with Luxembourg (1967) and the Netherlands (1967) if the recipient company controls at least 25 per cent of the voting stock of the distributing entity. A 2.5 per cent withholding tax is imposed under the Luxembourg-Netherlands treaty if the recipient entity own directly at least 25 per cent of the capital of the distributing entity in the other treaty country.19/

Under most treaties concluded by the Federal Republic of Germany, 20/ German withholding tax is collected at the statutory rate of 25 per cent if the corporate shareholder in the other treaty country owns at least 25 per cent - under some treaties, "more than" 25 per cent - of the voting stock of the German company. This deviation from the general rule, which provides for a reduced rate of withholding tax on intercompany distributions, is explained by the "split" German corporate tax rate. 21/ The increased withholding rate is meant to compensate for the "supplementary tax" that is imposed on German (but not foreign) corporations which fail to redistribute intercompany dividends received by them to their own shareholders or members. 22/ Another result of the "split" German corporate tax

18/ Tax Treaties between Developed and Developing Countries (United Nations publication, Sales No. E.69.XVI.2), p. 47, note 13.

19/ Dividends distributed by a Luxembourg holding company are not subject to Luxembourg withholding tax.

20/ The rule is not applied under the treaty of the Federal Republic with the United States of America (1954/1965).

21/ At present, the statutory tax rates are 15.45 per cent for distributed profits and 52.53 per cent for retained earnings.

22/ Apart from corporations and other entities that are taxed at special rates, such distributions are subject to supplementary tax at the rate of 37.08 per cent, i.e. the difference between the tax rates on distributed profits (15.45 per cent) and retained earnings (52.53 per cent).

rate is the unique provision in the treaty between the United States of America and the Federal Republic of Germany under which the usual treaty withholding rate of 15 per cent is increased to the German statutory rate of 25 per cent for dividends of a German subsidiary which are "reinvested" by the parent in the subsidiary.

Treaties between developed and developing countries

As happens between developed countries, the conventions between developed and developing nations show considerable variety in the measures adopted to eliminate or mitigate the double taxation of dividends. Basically, the number of relief measures available for this purpose is limited - removal or reduction of the withholding tax of the source country and exemption, rate reductions or the foreign tax credit (sometimes combined with an indirect or tax-sparing credit) at the shareholder's residence. However, even these few relief mechanisms lend themselves to numerous combinations and variations; in addition, there often are differences between the treatment of intercompany dividends and other distributions.

Distributions other than intercompany dividends

The two possible extremes in the international tax treatment of corporate dividends are full taxation of the dividend in the source country and exemption of this income in the shareholder's country of residence on the one hand; and full taxation of the income at the shareholder's residence combined with exemption at the source on the other. 23/ Both methods have been used, although neither one can be said to reflect a prevalent treaty practice.

Exclusive taxation of dividends at the domicile of the distributing corporation, with exemption in the shareholder's country of residence, is provided under the treaties of India with Austria (1963), Denmark (1950), Finland (1961), Greece (1965) and Sweden (1958) and the treaties of Sweden with Argentina (1962), Peru (1966) and Thailand (1961). Some of the treaties named include an "exemption with progression" clause. 24/ Exemption of dividend income at the source, combined with full taxation of the income at the shareholder's residence, is the rule under the treaties of the United Kingdom with Burma (1950/1951), provided that the shareholder is subject to tax on the dividend in his home country, Jamaica (1965/1969), Malaysia (1963/1967), and Singapore (1966), subject to the further qualification, under some of these treaties, that the holding giving rise to the dividend is not effectively connected with a permanent establishment maintained by the shareholder in the other treaty country. A similar rule applies under the treaties of Denmark with Ceylon* (1963) and Singapore (1969), the treaty between Japan and Zambia (1970), and the treaty between Ceylon and Norway (1964). 25/

* Now designated as Sri Lanka.

23/ See paper submitted to the Group of Experts at its first meeting by the member from India, December 1968 (paper No. 1 and Add.1).

24/ See Austria-India, article XVII(4) and Argentina-Sweden, articles XVI(3) and (4).

25/ These treaties also remove the exemption at the source if the holding from which the dividend is derived is attributable to, or effectively connected with, a permanent establishment maintained by the shareholder in the source country.

However, Denmark and Norway retain the right to levy a 5 per cent dividend withholding tax under their treaties with Ceylon.

The majority of the treaties surveyed provide for division of tax jurisdiction between the contracting countries, i.e. reduction of the statutory withholding tax in the source country and limited taxation of the dividend income at the shareholder's residence.

Under a number of treaties, the rate of the dividend withholding tax is the same in both contracting States regardless of whether the developed country or the developing country is the country of domicile of the distributing corporation. Examples of such treaties are the conventions of Israel with the United Kingdom (1962/1970) (15 per cent) ^{26/} and the United States of America (1965; not ratified) (25 per cent); between Brazil and Norway (1967); ^{27/} between Japan and the Republic of Korea (1970) (12 per cent); Japan and the Federation of Malaysia (1963) (15 per cent) and Japan and Singapore (1961) (15 per cent). These treaties also remove the reduction of the withholding tax if the holding from which the dividend is derived is effectively connected with a permanent establishment in the source country.

Under some treaties, different rates of withholding tax are applied by the Contracting States. Such differences reflect, in some cases, the unequal bargaining position of the negotiating parties, in others conflicting concepts regarding the taxation of a corporation and its shareholders and the integration of the two objects of taxation, and in still others, non-tax policy decisions by one of the treaty countries. An interesting example of the latter approach is found in the treaties of the United States with Brazil (1967, not ratified) and Trinidad and Tobago (1970). Under these treaties, the withholding taxes of Brazil and Trinidad and Tobago are reduced, but the United States withholding tax is preserved at the full statutory rate of 30 per cent in order to discourage outflows of capital from the two developing countries to the industrialized country.

The relief measures granted by the investor's country of residence - usually the developed country, but under some treaties, also the developing country - are discussed below.

Direct foreign tax credit

Only a direct foreign tax credit for the dividend withholding tax of the other treaty country is granted under a number of conventions, including those between Denmark and Pakistan (1961), Egypt and Sweden (1958), Jamaica and the United

^{26/} This rule shall apply, according to article VI(2) of the revised treaty, even though distributed profits are deducted in computing the corporation profits tax of an Israeli corporation (see International Tax Agreements, vol. IX, Supplement No. 23, Convention 258, Israel-United Kingdom (United Nations publication, Sales No. E.70.XVI.4)).

^{27/} The withholding tax under this treaty is 25 per cent which is the statutory withholding rate in both Brazil and Norway. In effect, the treaty "freezes" the statutory rates, but it does not reduce them.

Kingdom (1965/1969), and Singapore and Sweden (1968). The last-named treaty has the unusual feature that the foreign tax credit granted by Sweden is limited to 15 per cent of the net dividend distributed by the Singapore company (i.e. the amount of the gross dividend reduced by the Singapore corporation tax attributable thereto) as long as Singapore does not have a dividend withholding tax in the traditional sense. If and when such a tax is introduced, the credit shall be computed (at the rate of 15 per cent) on the gross amount of the dividend, as is usually the case under tax treaties. The effective period of this provision is limited to 10 years, counted from the effective date of the convention, and may be extended.

The direct foreign tax credit is also the only relief granted by the United States of America under its treaties with developing countries, of which only two are presently in effect, 28/ in accordance with the statutory law of that country, which limits the use of the indirect or "deemed-paid" credit to corporate taxpayers. 29/

Direct and deemed-paid foreign tax credit

A number of treaties permit a noncorporate shareholder to claim an indirect (deemed-paid) foreign tax credit for the part of the income tax of the distributing corporation that corresponds to the amount of the dividend distributed by it to the shareholder. Such a credit is granted by Israel under its treaties with Denmark (1966), Norway (1966) and Sweden (1959), 30/ and by the United Kingdom under its treaties with Burma (1951/1952) and Malaysia (1963/1967).

Tax-sparing credit

A significant number of tax conventions between developed and developing countries include a credit for taxes of the developing country that are reduced or forgiven under its incentive legislation. (For a summary of the treaties including such a provision, see "Principal relief measures applied by capital-exporting countries--The tax-sparing credit". 31/)

Intercompany dividends

A number of treaties between developed and developing countries do not

28/ Pakistan (1957) and Trinidad and Tobago (1970).

29/ Internal Revenue Code of 1954, as amended, section 902. The United Kingdom introduced the same limitation by the Finance Act, 1965, but not all of its treaties have as yet been conformed to this rule.

30/ Under the treaties with Denmark and Norway, the aggregate amount of the direct and deemed-paid foreign tax credits granted by Israel is limited to 25 per cent of the gross dividend (Denmark-Israel, article 24; Israel-Norway, article 24).

31/ Tax Treaties between Developed and Developing Countries: First Report (United Nations publication, Sales No. E.69.XVI.2), part II, paras. 24-34.

differentiate between intercompany dividends and other distributions, although this rule cannot be described as either prevalent or exceptional. The following summary is limited to treaties that include special rules with respect to intercompany distributions.

Treaty benefits extended by the source country

Pakistan reduces its supertax on dividends under the treaties with Austria (1970), Denmark (1961), the Federal Republic of Germany (1963/1970) and the United Kingdom (1961) if the dividends are paid from the profits of an industrial undertaking and the corporate shareholder in the other treaty country holds a substantial investment in the Pakistan corporation. ^{32/} A similar rule applies under the treaties of Thailand with Denmark (1965), Norway (1964) and Sweden (1961). ^{33/} Reflecting different policy considerations, Israel retains its statutory withholding tax at the full rate under the treaties with Denmark (1966), Finland (1965) and Norway (1966), whereas the three countries named reduce their withholding rates under the treaties from 15 to 5 per cent on dividends paid by one of their corporations to an Israeli company holding an equity investment of at least 50 per cent. The treaty between Israel and Sweden (1959), on the other hand, provides for exemption from Israel withholding tax in favour of dividends paid to a Swedish corporation holding a 50 per cent or greater participation in the equity capital of an Israeli company if the income from which the dividend is paid was taxed in Israel; conversely, the dividend is taxed in Israel at the full corporate rate if the income was not so taxed. Since the Israel-Sweden treaty is older than the other conventions referred to, the principles followed by it may no longer be applicable.

In an exceptional case, the tax of the source country is heavier on intercompany dividends than it is on other distributions. Thus, Ceylon which generally waives its dividend withholding tax under tax treaties, reserves the right to collect a special 6 per cent tax ^{34/} (which is not applicable in the case of other distributions) under the treaties with Denmark (1963), the Federal Republic of Germany (1962) and Norway (1964). On the other hand, the fact that the income is taxed in Ceylon results in its being exempt in Denmark and Norway. The income is also exempt under the treaty of Ceylon with the Federal Republic of Germany if the German corporate shareholder owns 25 per cent or more of the voting stock of the Ceylon company.

Another special rule which is designed to combat the abuse of tax treaties applies under the conventions of the United Kingdom with Cyprus (1947), Israel (1962/1970), Jamaica (1965), Malaysia (1963/1967) and Singapore (1966). The general rule under these treaties is that dividends are exempt from the tax of the source country or subject only to a limited withholding tax, if the recipient of the

^{32/} The required minimum investment is 25 per cent under the treaty with Austria, 33 1/3 per cent under the treaties with Denmark and the Federal Republic of Germany, and more than 50 per cent under the treaty with the United Kingdom.

^{33/} The required minimum investment is 25 per cent and the withholding rate is reduced to 20 per cent under the treaties named.

^{34/} This tax is described as a tax on companies whose shares are not movable property situated in Ceylon for purposes of the law relating to estate duty.

dividend is a company owning 10 per cent or more of the shares on which the dividend is paid, and if it is evident that the dividend was paid out of profits which the distributing company had earned, or from other income it had received, during the 12-month period 35/ ending on the date when the beneficial owner of the dividend became the holder of 10 per cent of the shares. This rule does not apply if it can be shown that the acquisition of the shares was made for bona fide commercial reasons and not for the primary purpose of securing the exemption or rate reduction under the treaty.

Tax benefits extended by shareholder's country of residence

The tax benefits extended by the corporate shareholder's country of residence are not different from those that apply to dividends other than intercompany distributions. None of the relief methods applied - foreign tax credit with or without a deemed paid credit or a tax-sparing credit, and exemption with or without progression - can be described as prevalent. Unlike the rule which applies under other conventions, the exemption of dividends from Swedish tax under the Singapore-Sweden treaty (1968) is made dependent on a showing that the principal part of the profits of the Singapore company paying the dividend arose, directly or indirectly, from business activities other than the management of securities or other movable property, and that these activities were carried on in Singapore by the company paying the dividend, or by another company whose shares the distributing company owned to the extent of at least 25 per cent. Exemption, in the developed country, of intercompany dividends received from corporations in developing countries is the rule under the treaties between Denmark and the Philippines (1966), Brazil and Norway (1967), and the treaties of Sweden with Brazil (1965), Israel (1959) and the Philippines (1966). The rule is reciprocal under the last-named treaty. Except for the convention with the United Arab Republic* (1959), the Federal Republic of Germany exempts intercompany dividends under its treaties with developing countries 36/ if the German company owns at least 25 per cent (under some treaties, more than 25 per cent) of the share capital of the distributing corporation.

Other issues

Definition of dividend

A number of tax treaties include a definition of the term "dividend", 37/ primarily to distinguish distributions on equity investments from interest payments

* Now designated as Egypt.

35/ In the treaties with Malaysia and Singapore, the wording is "twelve months or more".

36/ For example, under the treaties with Argentina (1966), Ceylon (1962), India (1959), Iran (1968), Israel (1962), Pakistan (1958) and Thailand (1967).

37/ See, among others, Denmark-Israel (1966); Argentina-Federal Republic of Germany (1966) (including distributions on investment certificates); Ceylon-Federal Republic of Germany (1962) (including distributions by limited liability companies); Japan-Zambia (1970); Brazil-Norway (1967); Israel-Norway (1966); Israel-United Kingdom (1962/1970).

on debt claims. In general, the treaty definitions closely follow the wording of article 10(3) of the OECD Model Convention.

Source rules

Some treaties include a provision defining the geographical source of dividend income. Almost without exception, this source is placed in the country in which the distributing corporation is domiciled. 38/ The purpose of this rule is to obviate jurisdictional problems which may arise where a corporation derives a significant portion of its income from sources outside its country of incorporation. A few conventions specifically cover this situation. 39/

Distributions by non-resident corporations

Certain countries tax not only dividends distributed by their own corporations, but distributions by non-resident corporations to the extent that such distributions are made from profits arising in those countries. Article 10(5) of the Model Convention precludes this form of taxation (except in so far as the recipient of the dividend is a resident of the source country), as well as the imposition of undistributed profits taxes on corporations of the other treaty country. A comparatively large number of conventions include this provision. 40/

38/ See Japan-Republic of Korea (1970); Singapore-Sweden (1968).

39/ See treaties of the United States of America with Brazil (1967) (not ratified), article 5(1), and with Trinidad and Tobago (1970), article 5(1)(b) and article 12(5).

40/ See, among many other treaties, Austria-Pakistan (1970), article V(4); Ceylon-Denmark (1963) article VI(4); Federal Republic of Germany-Pakistan (1970 protocol), article VI(4); Norway-Thailand (1964) article 10(2); and Singapore-Sweden (1968), article VII(5).

II. EXCHANGE OF INFORMATION FOR THE PREVENTION OF INTERNATIONAL TAX EVASION AND AVOIDANCE

A. Introduction

The guidelines for this study, as set forth in the report of the Ad Hoc Expert Group on Tax Treaties between Developed and Developing Countries on its third meeting, 1/ were prescribed as follows:

"169. The various subjects to be explored in the study on exchanges of information would include:

(a) The aspect of a tax administration furnishing information in response to a specific request made by another tax administration;

(b) The aspect of a tax administration furnishing information it believes of assistance to another tax administration where an investigation or other matter carried on in the first country independently develops the information;

(c) The aspect of automatic furnishing of information that is considered as generally useful to the tax administration of the recipient country and feasible of being furnished by the tax administration of the country producing the information.

170. The study would consider the various matters involved in exchanges of information, such as: the nature of the methods of evasion being utilized and the kinds of information that would be useful in countering that evasion; the importance of the information to the country desiring it, and the feasibility of its being used by that country; the feasibility of the furnishing of the information, including applicable limitations in law and practice; the effect on the competitive position of taxpayers involved as a result of differing practices regarding the disclosure of information and the consequent need for as wide a co-operation on the part of all Governments as is feasible; the authorities in the recipient country who will be permitted to use the information furnished; and any other relevant matters."

* In the preparation of this chapter, the United Nations Secretariat had the assistance of Harold C. Wilkenfeld, United States Department of Justice, Washington, D.C., who acted as a consultant.

1/ Tax Treaties between Developed and Developing Countries: Third Report (United Nations publication, Sales No. E.72.XVI.4), p. 26.

B. Definitions

For purposes of clarification, certain terms require definition:

Fraud and fiscal evasion

These terms are frequently used in exchange of information provisions. "Fraud" and "fiscal evasion" appear to have the same practical meaning - the repetition apparently being intended to accommodate to possibly differing terminology of the respective laws. In the context of the laws of some countries, fraud may connote a wilful violation of the law, which, however, is not so serious as to merit criminal prosecution. In such situations a "fraud penalty" may be imposed. Fiscal evasion in this context may correlatively be defined as wilful violation of the law with respect to which criminal prosecution is appropriate. Policies of treaty partners with respect to actual imposition of fraud penalties or institution of criminal proceedings may also differ widely.

Tax evasion

Tax evasion is used herein as the equivalent of fraud and fiscal evasion. It has been defined as "a wilful, deliberate violation of law in order to escape payment of a tax which is unquestionably imposed on international income by the laws of the taxing jurisdiction" (ST/SG/AC.8/R.20). For purposes of this paper, international tax evasion will include cases in which "international income" is not necessarily involved, but where international boundaries are crossed by the defrauding taxpayer or other persons involved, the transaction, money or other assets.

Tax avoidance

Although in some dictionaries the words "avoidance" and "evasion" are used interchangeably to define each other, they have taken on a specialized connotation in tax administration. 2/ Evasion is generally defined, as suggested above, as constituting a wilful violation meriting punishment. Avoidance consists of the use by the taxpayer of means permitted by or within the law to minimize his tax liability. Sometimes the alternative courses available to the taxpayer supply a reasonable business choice, but most often, especially in international tax avoidance, the method employed is highly contrived. Depending upon how artificial the avoidance structure is, it may come uncomfortably close to tax evasion. The problem of drawing the line is often difficult for taxpayers, their tax counsel and the tax administration.

2/ The tendency to confuse the two terms is illustrated in section 482 of the United States Internal Revenue Code, where "evasion" was used when "avoidance" was meant. See Asiatic Petroleum Co. v. Commissioner, 79 F. 2d 234, 236 (C.A.2, 1935); certiorari denied 56 S.Ct. 369. Section 482 authorizes the tax authorities to reallocate income and other items between related entities in order "to prevent evasion (read "avoidance") of taxes or clearly to reflect the income". This provision has parallels in many tax conventions, e.g. OECD Model Convention, article 9.

Substance versus form

Many tax laws contain express provisions authorizing the tax authorities to ignore the form of a transaction where it is merely a façade to hide reality. Where not expressed by statute, the substance versus form principle is often developed by court decisions. This is another way of approaching the line between tax avoidance and tax evasion, although the substance versus form principle is most frequently applied in tax avoidance situations. Outstanding examples are treaty provisions permitting reallocations of income or deductions between related businesses which have not dealt with each other at arm's length.

Bilateral and multilateral international tax evasion

These terms are newly coined for this study. Bilateral international tax evasion is applied to evasion in which only two countries are affected, although the tax laws of only one may have been violated; multilateral international tax evasion is applied where three or more countries are affected. A number of examples of what is here denominated as bilateral international tax evasion (as well as several examples of multilateral international tax evasion) are outlined in the paper entitled "Simple methods of international income tax evasion" (ST/SG/AC.8/R.20). For reasons which are elaborated later in this paper, these distinctions have practical significance.

C. Analysis of exchange of information articles

The Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, prepared by the Organisation for Economic Co-operation and Development (OECD), 3/ furnishes a logical starting point for this discussion of treaty provisions relating to the exchange of information with a view toward preventing international tax evasion. The pertinent provisions of the Model Convention will be analysed and compared with provisions of several conventions in force in order to identify the extent to which exchange of information provisions have been elaborated or limited in actual practice.

The OECD Model Convention contains several exchange of information provisions which will be discussed here in the order in which they appear in the Convention.

(a) Article 2, paragraph 4 provides that at the end of each year "the competent authorities of the Contracting States shall notify to each other any changes which may have been made in their respective taxation laws". The significance of this provision, in the context of article 26 (later discussed), is that the latter article (paragraph 1) provides for the "exchange of such information as is necessary for the carrying out... of the domestic laws of the contracting States concerning taxes covered by this Convention..."; and article 2, paragraph 4, provides that the Convention shall apply, in addition to taxes in effect when it enters in force, "to any identical or substantially similar taxes which are subsequently imposed in addition to, or in place of, the existing taxes". There may be need for clarification as to whether subsequently enacted administrative

3/ Organisation for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital (Paris, 1963), p. 36.

and penal provisions are also intended to be incorporated by article 2 into the exchange of information provisions of article 26;

(b) Provisions for determinations or mutual agreements by the competent authorities of the Contracting States contemplate, by clear implication, the exchange of such information as may be necessary to make a determination or to arrive at an agreement. Such provisions are:

- (i) Article 4, paragraph 2(d) provides that in the case of an individual whose fiscal domicile cannot otherwise be determined and who is a national of both Contracting States, or of neither of them, the competent authorities shall settle the question by mutual agreement, presumably in accordance with the procedure provided by article 25;
- (ii) Article 10, paragraph 2, in prescribing percentage limitations upon taxation of dividends, provides that the mode of application of the limitation shall be settled by mutual agreement of the competent authorities. Since, under this article, application of the reduced rate of 5 per cent (rather than the standard 15 per cent rate) depends upon whether the recipient of the dividends is a company "which holds directly at least 25 per cent of the capital of the company paying the dividends", exchange of information to ascertain such ownership is presumably contemplated. It is not clear, however, whether the competent authorities are also intended to settle, by mutual agreement, the application of other subsequent limitations contained in article 10, such as whether the definition of "dividends", contained in paragraph 3, is satisfied, or whether the recipient of the dividends has a permanent establishment in the Contracting State in which the company paying the dividends is a resident. It should be observed that, unlike article 4 (mentioned above), articles 5 and 7, the former of which defines "permanent establishment", and the latter of which prescribes the manner of taxation of business profits derived by an enterprise of one Contracting State carrying on business in the other Contracting State through a permanent establishment, do not specifically provide for mutual agreement between the competent authorities as to whether a permanent establishment does in fact exist. It may be that this situation, as well as similar problems which may arise under other articles of the convention (such as those dealing with interest, royalties, capital gains, personal services etc.) are intended to be alleviated by the mutual agreement procedure of articles 25 and 26. If so, the question arises whether the separate competent authority provisions of articles 4 and 10 may not be redundant. Query, also, whether under the principle of inclusio unius exclusio alterius the provisions of articles 25 and 26 might be construed as inapplicable to articles 4 and 10. This is obviously not intended, and may merit clarification;
- (iii) Article 11, paragraph 2, in imposing a 10 per cent maximum tax rate to be imposed by a Contracting State upon interest arising therein, but payable to a resident of the other Contracting State, provides that the competent authorities "shall by mutual agreement settle the mode of application of this limitation". The comments, above, relating to the comparable provision in article 10, paragraph 2, apply mutatis mutandis to this provision.

(c) By way of contrast, there is no specific competent authority procedure provided in several other articles dealing with the taxation of particular varieties of income.

- (i) These include article 6 - income from immovable property taxable where situated; article 7 - business profits of an enterprise of a Contracting State taxable only by that State, unless the enterprise has a permanent establishment in the other Contracting State; article 12 - royalties taxable only in the State in which the recipient resides, unless the recipient has a permanent establishment in the other State; article 13 - capital gains from immovable and movable property - the former turning on situation, and the latter subject to special factual rules; see also, as to particular varieties of incomes of individuals, articles 14 through 21.
- (ii) More specifically, it should be observed that several articles dealing with possible evasion or avoidance by improper shifting of income between or among related persons do not expressly provide for exchange of information between the competent authorities. This seems, however, to be accomplished by article 26. The articles referred to are article 11, paragraph 6 (interest) and article 12, paragraph 4 (royalties). The paragraphs referred to similarly provide that where "owing to a special relationship between the payer and the recipient or between both of them and some other person" the amount paid, considering specified circumstances, "exceeds the amount which would have been agreed upon by the payer and recipient in the absence of such relationship" then "the excess part of the payments shall remain taxable according to the law of each Contracting State...". These provisions are designed to overcome specific tax avoidance devices involving overpayments, but they do not consider the possibility that in some cases related parties may find it advantageous to waive or undercharge interest, royalties or similar items.
- (iii) There is also no specific provision for exchange of information in what is probably the most important article of the OECD Model Convention, directed explicitly to the prevention of international tax avoidance or evasion. This is article 9, relating to "associated enterprises", which provides that "where (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the Contracting State, or (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."

Essentially, the standard expressed by this article is the so-called "arm's length" rule, applied by the laws or judicial decisions of several countries, in reallocating income, expenses or deductions between or among commonly controlled enterprises. (See, for example, section 482 of the United States Internal Revenue Code.) The "independent enterprise" or arm's length concept presupposes that the taxing authorities have in their possession (a) all of the facts pertaining to the

questionable transactions between or among the associated enterprises, and (b) a reliable standard against which to measure the questionable transactions, preferably in the form of evidence of comparable transactions between independent enterprises.

Experience has shown that, difficult as the application of the arm's length standard may be in purely domestic situations, the difficulties are compounded manyfold when international transactions are involved. Assembling the details of a frequently multiparty transaction is difficult enough when one or more of the parties are situated abroad; getting third-party data pertaining to an independent comparable is even more difficult. Accordingly, if article 9 is to be implemented effectively and fairly, mutual exchange of information through the competent authorities appears to be an essential prerequisite. Since convenient arrangements between related enterprises are common tax avoidance devices, and since the equivalent of article 26, as carried into many treaties, is limited to fraud or evasion, a specific exchange of information provision may be desirable in this article. This may not, however, be necessary if the Contracting Parties mutually construe the standard opening clause of article 26, relating to exchange of information necessary for carrying out the Convention, as incorporating unilateral or bilateral applications of article 9.

Reallocation of profits (article 9), and interest (article 11, paragraph (6) or royalties (article 12, paragraph 4) may give rise to double taxation. So also may adjustments made under other convention articles, although those cited above are the most likely to involve instances of tax evasion or substantial avoidance.

Article 25 of the OECD Model Convention contemplates that where a resident of one Contracting State considers that he has been, or will be, subjected to double taxation, contrary to the Convention, by reason of the actions of one or both of the Contracting States, he may present his case to the competent authority of his State (paragraph 1); and, if the objection appears to be justified, and if an appropriate solution cannot otherwise be found, the competent authorities of both Contracting States shall endeavour to resolve the case by mutual agreement (paragraph 2).

Since the resolution of such a case of alleged double taxation would presumably have to be based upon consideration of all pertinent facts, the article must logically presuppose that the respective competent authorities will seek to obtain, from their respectively available sources, all information necessary to resolve the issue; and, also, that they will exchange this information with each other so that both may agree mutually as to its significance. The article makes no provision for representation of the aggrieved resident, and the proceedings may apparently be conducted ex parte. There seems to be no inhibition, however, upon permitting the affected taxpayer to make appropriate representations.

This competent authority appeal procedure is unlikely to be resorted to by a taxpayer who had engaged in tax evasion or a blatant tax-avoidance device. Such a taxpayer would not wish to risk the possibility that, in order to consider his case, additional information may be sought from him or other parties, which, when coupled with information available already to both competent authorities, might deny him the relief sought while subjecting him to additional difficulties. Accordingly, such a taxpayer may conclude that accepting the double taxation effect is the lesser evil.

This brings us to the most important exchange of information provision of the OECD Model Convention, namely, article 26, which provides as follows:

"1. The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention in so far as the taxation thereunder is in accordance with this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons or authorities other than those concerned with the assessment or collection of the taxes which are the subject of the Convention.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:

- (a) to carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;
- (b) to supply particulars which are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
- (c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy."

(a) The key to article 26 is the first sentence of paragraph 1: the rest is limitation or commentary. Significantly, this exchange of information provision goes beyond the scope of many such provisions in conventions now in force. The OECD Draft Convention contemplates that information shall be exchanged (read "supplied") as is necessary for carrying out either the convention or the pertinent domestic tax laws of the Contracting States. No mention is made of fraud or evasion. Consequently, the OECD draft contemplates that information shall be supplied for all necessary purposes, whether or not involving fraud.

Few nations have been willing to go so far in actual practice. Among those few are France and Finland, in their convention signed in 1970; France and Brazil in their 1971 convention; and Belgium's 1970 conventions with Italy, the Netherlands and Spain. Most often (as in article 26 of the double taxation convention negotiated between Japan and the United States in 1971) exchange of information is limited to such as is pertinent to carrying out the provisions of the convention "or preventing fraud or fiscal evasion" in relation to the taxes which are the subject of the convention (see also the 1965 convention between France and Italy). Even more limited in scope is the convention negotiated in 1970 between Japan and the Republic of Zambia, which calls for exchange of only such information as is necessary for carrying out the convention. The convention between the German Federal Republic and Iran, signed in 1968, is similar; as is the convention signed in 1971 between the German Federal Republic and Switzerland. The 1970 convention between Japan and the Netherlands contains no exchange of information provision (but see article 27, permitting direct communication between the competent authorities). Another variation is a provision for exchange of information (a) for carrying out the provisions of the convention, (b) for the prevention of fraud and (c) for the administration of statutory provisions against tax avoidance in relation to the taxes which are the subject of the convention; such provisions being contained, for example, in the 1967 convention between

Japan and Ceylon,* and in the 1968 convention between Malaysia and Singapore. We thus see that there has been a singular lack of uniformity in respect of the terms of exchange of information provisions. They range from complete exchange of information, following the OECD draft, to no mention of exchange of information, with a range of intermediate variations.

(b) A secrecy provision, similar to the OECD draft, article 26, paragraph 1, second sentence is almost universal. Disclosure is permitted under the OECD draft to persons or authorities concerned with the assessment or collection of the taxes covered by the convention. Although some conventions spell out that this includes a court or administrative body concerned with enforcement or prosecution in addition to assessment and collection, (see, for example, article 26(1) of the Japan-United States convention), it may be asserted that the OECD draft and similar conventions have the same intention. Under the broadest interpretation, the secrecy provision still limits exchange of information to the treaty partners and their respective authorities. This limitation may produce anomalous results in instances of tax evasion schemes involving one or more countries in addition to the treaty partners. Even if such other countries also are parties to double-taxation agreements with each of the treaty partners, the effect of the secrecy provision may be to inhibit exchange of information with other affected countries - which may defeat efforts to prevent multilateral tax evasion.

The income tax treaty between Japan and the United States signed in March 1971 is a merger of pre-existing patterns of treaties between the parties and with other countries, the OECD Draft Convention and specific provisions tailored to the characteristics of the laws and practical experience of each of the treaty partners. The substantive source rules, definitions and agreements as to jurisdiction to tax specific types of income are more elaborate than those in many other treaties. Since the two provisions which lay the foundation for exchanges of information between the Contracting States specifically cover or anticipate a wide range of contacts between the States, these provisions merit quotation in haec verba. They provide:

"Article 25

1. Where a resident of a Contracting State considers that the action of one or both of the Contracting States results or will result for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident. Should the resident's claim be considered to have merit by the competent authority of the Contracting State to which the claim is made, it shall endeavour to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation contrary to the provisions of this Convention.

2. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of this Convention. In particular, the competent authorities of the Contracting States may consult together to endeavour to agree:

* Now designated as Sri Lanka.

(a) To the same attribution of industrial or commercial profits to a resident of a Contracting State and its permanent establishment situated in the other Contracting State;

(b) To the same allocation of income, deductions, credits or allowances between a resident of a Contracting State and any related persons;

(c) To the same determination of the source of particular items of income; or

(d) To the same meaning of any term used in this Convention.

3. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of this article. When it seems advisable for the purpose of reaching agreement, the competent authorities may meet together for an oral exchange of opinions.

4. In the event that the competent authorities reach such an agreement, taxes shall be imposed, and refund or credit of taxes shall be allowed, by the Contracting States in accordance with such agreement.

Article 26

1. The competent authorities of the Contracting States shall exchange such information as is pertinent to carrying out the provisions of this Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than those (including a court or administrative body) concerned with assessment, collection, enforcement or prosecution in respect of the taxes which are the subject of this Convention.

2. In no case shall the provisions of paragraph (1) of this article be construed so as to impose on a Contracting State the obligation:

(a) To carry out administrative measures at variance with the laws or the administrative practice of that Contracting State or the other Contracting State;

(b) To supply particulars which are not obtainable under the laws or in the normal course of the administration of that Contracting State or of the other Contracting State; or

(c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

3. The exchange of information shall be either on a routine basis or on request with reference to particular cases.

4. The competent authorities of the Contracting States shall notify each other of any amendments of the laws relating to the taxes referred to in paragraph (1) of article 1 and of the adoption of any taxes referred to in

paragraph (2) of article 1 by transmitting the texts of any amendments or new statutes at least once a year.

5. The competent authorities of the Contracting States shall exchange the texts of all published material interpreting this Convention under their respective laws, whether in the form of regulations, rulings or judicial decisions."

As mentioned earlier, articles 25 and 26 of the Japan-United States treaty are more elaborate than comparable provisions in other treaties. A provision which is gaining in usage is article 27, providing for mutual assistance in collection to prevent enjoyment of treaty benefits by persons not entitled thereto. Since this also presupposes exchange of information between the competent authorities, the explicit terms are set out below:

"Article 27

1. Subject to the provisions of paragraph (2) of this article, each of the Contracting States shall endeavour to collect such taxes imposed by the other Contracting States as will ensure that any exemption or reduced rate of tax granted under this Convention by that other Contracting State shall not be enjoyed by persons not entitled to such benefits. The Contracting State making such collections shall be responsible to the other Contracting State for the sums thus collected. The competent authorities of the Contracting States may consult together for the purpose of giving effect to this article.

2. In no case shall this article be construed so as to impose upon a Contracting State the obligation to carry out administrative measures at variance with regulations and practices of either Contracting State or which would be contrary to the first-mentioned Contracting State's sovereignty, security or public policy."

It should be noted that this provision is limited to collection assistance to prevent abuse of the Convention. It does not extend to general collection assistance, still a relative rarity among double-taxation conventions.

One of the broadest exchange of information provisions is contained in the convention signed in 1968 between Malaysia and Singapore. Article XIX of that convention provides:

"1. The taxation authorities of the Contracting States shall exchange such information (being information which is available under their respective taxation laws in the normal course of administration) as is necessary for carrying out the provisions of this Agreement or for the prevention of fraud or underpayment of taxes by reasons other than fraud or for the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of this Agreement. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than persons, including a court, concerned with the assessment and collection of those taxes or the determination of appeals in relation thereto.

2. /This provision has limitations substantially identical to those of article 26 (2) of the OECD Model Convention./"

In scope, this provision is not quite the substantive equivalent of article 26 of the OECD Model Convention, although, by including information "for the administration of provisions against legal avoidance in relation to the taxes which are the subject of this agreement", it goes beyond those treaties, such as the one between Japan and the United States, which have the "fraud or fiscal evasion" limitation. The Malaysia-Singapore convention does not, however, go so far as the Japan-United States convention in respect of mutual assistance in collecting taxes from persons not entitled to the benefits of the convention; but the provision for exchanges of information "for the prevention of ... underpayment of taxes by reasons other than fraud" - not being limited to the Convention - goes beyond the Japan-United States convention in this respect although it is still within the scope of the OECD model.

D. Some potential legal problems

The investigative powers of the revenue authorities, being determined by law and practice, vary considerably in different countries. This fact is recognized in the standard exchange of information provision (see, e.g. OECD Draft, article 26 (2)), which relieves the Contracting States of the obligation (a) to carry out administrative measures at variance with the laws or administrative practice of either State; (b) to supply particulars not obtainable under the laws or in the normal course of administration in either State; or (c) to supply information which is confidential (such as trade or professional secrets) or whose disclosure is contrary to public policy (ordre public).

The net effect of the above-mentioned qualifications upon "the obligation" to supply information is to reduce obligatory exchanges to a "least common denominator", i. e. a State whose laws and procedures give broad investigative powers to its tax authorities is not obliged, nevertheless, to supply more information than is normally obtainable by the tax authorities of the other State. There are, therefore, two essential preliminary prerequisites to a request for information which one State may address to its treaty partner. The first, implicit in the standard secrecy provision, requires that the requested State be assured that the information is to be used solely for relevant tax purposes. Some problems arising under this "secrecy" provision are discussed elsewhere in this paper. The restrictions presently under consideration further require that the requested State be assured that the information is of a variety which would be obtainable in the requesting State and, also, that the administrative measures which must be taken in order to supply the information are in accord with the laws and administrative practices in both States.

Assuming that the information requested is already in the possession of the requested State or can be readily obtained under the laws and administrative practice of the requested State, the latter may, nevertheless, be under no treaty obligation to supply it. Some difficult questions can be raised if the requested State still chooses to supply the requested information. The information, now in the possession of the requesting State, is of a variety which it could not have obtained in the normal course of its own administration, or was obtained by the requested State under laws or administrative practices which are at variance with those of the requesting State. The information, presumably helpful, is now intended to be used by the requesting State as a basis for criminal charges against the taxpayer, assert an administrative penalty or support a tax assessment. Can the taxpayer (if the law of the requesting State permits) seek to prevent the use of such information on the ground that it had been obtained illegally?

There are two aspects to this question: (a) whether the requested State obtained the information legally when it used its own lawful procedures, even though they were at variance with the law and administrative practice of the other State; and (b) whether the requesting State illegally obtained information which the other State supplied voluntarily, being under no treaty obligation to do so.

Take, for example, the case of a citizen or resident of State A, who is now sojourning in State B. Under the constitution and laws of State A, one who may be charged with a crime (e. g. tax evasion) has the right to refuse to furnish information on the ground that it might tend to incriminate him; while under the constitution and laws of State B a potential accused can be compelled to testify. State A requests that information be obtained from the taxpayer by State B, and such information is then obtained and supplied to State A. The information consists of a statement, under oath, obtained by the competent authorities of State B, under their normal procedures in such cases, together with the originals of the taxpayer's books and records.

In the example postulated above, assuming that the competent authorities of State B were acquainted with the legal restrictions upon the investigative powers of State A's tax authorities, they could have respectfully declined to obtain the requested information; or they might have limited themselves to seeking to obtain the information pursuant to the procedures appropriate in State A. Then, if the taxpayer chose to co-operate and to waive his legal rights under the laws of State A, there would be no problem. Indeed, the treaty would have been complied with in terms. But the problem we are here concerned with assumes that the competent authorities of State B went beyond their obligations under the Convention.

The threshold question, then, is whether information forced from the taxpayer, consistent with State B's laws, but contrary to those of State A, and then voluntarily rather than obligatorily supplied, can be attacked as having been illegally obtained by States A and B. One could argue that the fact that the standard language of the exchange of information article provides that it shall not be construed as imposing "the obligation" to furnish the information under prescribed conditions was not intended to inhibit such information from being voluntarily supplied. It is suggested, however, that at least in criminal cases, and possibly even in standard tax liability cases, the laws of some States may nevertheless prohibit information so obtained from being used by the tax authorities of the requesting State.

Assuming, without prejudging, that information of the type postulated above may be subject to attack as having been illegally obtained, the question whether it would be admissible in evidence in the requesting State, in a criminal or civil proceeding, or whether it can otherwise be relied upon by the tax authorities, remains to be considered. It has been decided by the United States Supreme Court, for example, that illegally obtained evidence is not admissible in a criminal proceeding (Ker versus California, 374 U. S. 23 (1963); Mapp versus Ohio, 367 U. S. 643 (1961); Elkins versus United States, 364 U. S. 206 (1960)), and this rule might apply also to evidence held to have been supplied in contravention of the express language of a tax treaty. In a criminal case the treaty language is likely to be given a strict construction, which might invalidate information not obligatorily supplied.

The law in the United States is less clear as to the admissibility in a civil tax proceeding of information illegally obtained. In a recent civil tax case

(Suarez versus Commissioner, 58 T. C., No. 78) the United States Tax Court held that the Commissioner was barred from introducing illegally obtained evidence, and that a notice of deficiency (proposed assessment) which was admittedly based upon such evidence was not entitled to the usual presumption of correctness of the administrative determination. Then the Tax Court took the unprecedented step of imposing upon the Commissioner of Internal Revenue the burden of presenting proof to support the deficiency, which was independent of the tainted evidence.

Where a fraud penalty has been imposed, the burden of proving the existence of the fraud is, in any case, imposed upon the United States tax authorities. In fraud cases, it often happens that discovery and investigation of the fraud (as well as delays in assessing the tax while criminal aspects are being considered or prosecuted) will delay assertion of the tax liability until after the normal statute of limitations has expired. In many States there is a larger period for assessment in fraud cases or, as in the United States, there is no statute of limitations upon assessment in fraud cases. However, the extended period does not apply until fraud is proven. Otherwise, even an admitted tax liability may be barred by the statute of limitations. To the extent that the imposition of the fraud penalty (and extension of the statute of limitations) depends upon evidence which may be held to have been illegally obtained, the tax authorities will be unable to sustain the burden of proof. Consequently, cases such as Suarez bear watching, since they could have broad implications in relation to the treaty interpretation questions considered herein.

Some other recent developments specifically involving application of an exchange of information provision merit attention. As is generally known, Switzerland has strict laws protecting bank secrecy and prohibiting economic espionage. The interaction of these laws with the exchange of information provision in the income tax convention between Switzerland and the United States came to the fore in a recent case (X versus The Federal Tax Administration, a decision of the Swiss Federal Supreme Court, unofficially reported at 71-1 U. S. T. C. para. 9435 and 28 A. F. T. R. 2d 71-5510). After considering a series of preliminary interpretative questions, the Swiss Federal Supreme Court concluded that in cases of tax fraud the Swiss bank secrecy restrictions were lifted by the Convention and that the information requested by the United States competent authority could be supplied.

There is an aftermath of this case, which is still pending in the United States Tax Court. In Ryan versus Commissioner (Docket No. 4800-69), the United States competent authority, relying upon the Swiss decision previously mentioned, requested and obtained from the Swiss competent authority information with respect to the taxpayer's accounts in a Swiss bank. A civil tax liability was then asserted and an appeal therefrom was filed by the taxpayer in the Tax Court. The tax authorities, then being faced with the problem of converting the exchanged information into a form which would be admissible in evidence in a court proceeding, applied to the Tax Court for an order to permit the depositions of the Swiss bank officials to be taken by written interrogatories, identifying the bank records and accounts which it was desired to submit in evidence. Against vigorous objections of the taxpayer, the Tax Court concluded that by arrangement between the respective competent authorities, pursuant to article XVI of the Swiss-US Convention, the depositions on written interrogatories could be taken by the Swiss competent authority and transmitted to the Court via the United States competent authority (Ryan versus Commissioner, 58 T. C., No. 10.).

The problem which this procedure seeks to resolve is that the form in which the information was initially supplied, although sufficient to support the administrative action by the United States authorities, was not sufficient to satisfy the technical rules of evidence (such as the "hearsay rule") in force in the United States courts. This suggests that consideration might be given by the competent authorities in future cases of this nature to obtaining information on request in such manner and supplying it in such form that duplication of effort by the competent authorities would not be required. Such consideration is particularly pertinent in fraud and fiscal evasion cases, since future court proceedings can be reasonably anticipated. Legislation to render competent authority reports admissible in evidence might be considered, but this presents many technical difficulties.

The Ryan case, which is still sub judice, will bear further watching. The taxpayer has already taken an appeal from the Tax Court's order to the United States Court of Appeals. Even if the order is sustained, and the procedure therein provided is carried out, questions will almost certainly be raised as to the admissibility of the evidence thus obtained. The Tax Court, although approving the procedure, has expressly reserved ruling upon the admissibility of the evidence, and ultimately this question may have to be decided by a higher court.

One of the premises upon which the Swiss competent authority was held to be permitted to supply bank information to the United States competent authority was presumably that similar bank information would have been available to the United States competent authority under American law and practice. This is generally so, but a caveat should be entered on this point by reason of a decision of 11 September 1972 by a special three-judge court which had been convened in California to consider the constitutionality of certain provisions of the United States Bank Secrecy Act, which had been enacted in 1970. That court held that one of the provisions, requiring banks to report domestic banking transactions, violated the "right of privacy" under the Constitution. If this decision is ultimately sustained by the United States Supreme Court, it may require re-examination of the language and procedures under exchange of information provisions, at least in so far as the United States is concerned.

The purpose of the foregoing discussion has been to emphasize several practical considerations. To the extent that the laws and administrative practices of the Contracting States differ from each other in regard to the investigative powers of their tax authorities, the obligatory exchange of information is limited by the standard Convention provision to the most restrictive of the two. There is support for this limitation in the principle of reciprocity, which underlies most other Convention provisions. If the State having the more restricted investigative powers desires to have the benefit of information available under the broader powers of the other Contracting State, this would appear to be most effectively achievable by appropriate modification of the standard language of the exchange of information provision. This assumes, of course, that the other State will be willing to obligate itself to supply information, obtainable under its laws, of a type which it would not expect to receive reciprocally from the authorities of the other State. The formulation of specific treaty language to this end is probably more desirable than to rely upon the ad hoc willingness of one State to supply to the other information which it is not obliged to furnish. As indicated above, such information, even if voluntarily supplied, may raise difficult legal problems.

There are other possible solutions. It may be appropriate for States whose tax authorities are limited by law or practice to consider modifying their laws or

improving their administrative practices so as to broaden the scope of the investigative powers of the administration. This may, of course, present problems in particular States where traditions or political considerations favour continuing restrictions on the investigative authorities.

If a general extension of the laws and practices of a particular Contracting State may not be in order, consideration might be given to modifying the language of the standard exchange of information provision to permit the State with the lesser investigative powers to employ some or all of the greater investigative powers of the other State, when requested to do so. This would, however, present other theoretical and practical problems. To the extent that the modified Convention provision would oblige the requested State to employ procedures not otherwise available under its laws or administrative practices, the question would arise as to whether the Convention had the effect of overriding the general law of the State. This question would be especially vexing if the modified language of the Convention was or appeared to be in conflict with the constitutional rights of the taxpayer or third parties from whom information was being sought. The judicial tests to which such a provision would likely be subjected, and the restrictions which reviewing courts in the requested State might feel compelled to place upon it, might well render such a provision nugatory.

Even if an extension of the investigative powers were sustained by treaty, practical difficulties are likely to be encountered if the tax authorities of the requested State are expected to conduct an investigation in accordance with the laws and practices of the requesting State, rather than of their own State. Tax investigations are delicate and difficult. They are best conducted by experienced officials. An attempt by officials of one State to apply the laws and practices of another State might create more problems than it would solve.

There may, however, be a solution even to this problem, if extension of the investigative powers of the requested State's tax authorities otherwise appears to be desirable. That may be to permit a joint investigation in which investigators of the requesting State may be allowed to team up with investigators of the requested State. Such a joint investigation could be conducted under the common control of the respective competent authorities. This would at least assure that the procedures employed are in accord with those of the requesting State and that the respective laws are observed in accordance with the Convention. Another possible alternative is for the requested State to permit the investigation to be conducted exclusively by representatives of the tax authorities of the requesting State. Such an arrangement may be feasible where the taxpayer concerned is a citizen or resident of the requesting State and is willing to co-operate with the tax authorities of the State of which he is a citizen or in which he ordinarily resides. In the latter instance, an appropriate treaty provision, which may even override prohibitive statutes of the requested State (such as bank secrecy or economic espionage), might be considered.

The more difficult case is that of a citizen or resident of the requesting State who may be involved in fraud or fiscal evasion. In such cases, the investigation may have to be conducted without the suspected taxpayer's knowledge, let alone with his consent and co-operation. Yet this is the very type of situation intended by the "fraud and fiscal evasion" provision of a number of exchange of information articles. More experience with exchange of information in cases of this type will be necessary and, based upon such experience, revisions of treaty provisions and of internal laws and practices may have to be considered.

E. The administration's role in preventing tax evasion

In ST/SG/AC.8/R.20, a number of international tax evasion patterns were outlined. These were elaborated, to some extent in ST/SG/AC.8/R.20/Add.1, and ST/SG/AC.8/R.20/Add.1 (part two), dealing with international tax havens. Analysing these from the point of view of administrative experience, as reflected in the answers to the questionnaire, it may be postulated that the intricacy of tax-evasion techniques employed in a particular country is to a substantial degree correlated with the demonstrated ability of a country's tax administration to discover and punish tax evaders.

Countries differ from each other in respect of their commercial patterns, economic opportunities, nature of international trade, currency exchange limitations, cultural and political mores, and many other factors which may dictate or limit the situations in which tax evasion may be indulged in. The mixture of evasive devices most frequently employed by taxpayers in a particular country may be expected to change, just as the elements specified above are in a constant state of flux. For these reasons, it has been concluded that, for the practical purposes to which this paper is addressed, it would not be fruitful to analyse each of the simple and complex methods of international tax evasion which have been well elaborated in the documents referred to above. (See, however, "Analysis of a common tax-reducing device" below.) Instead, the problem of international exchange of information will be considered in the light of the procedural and legal problems which an administration encounters in seeking to identify international tax evasion, to punish it as may be appropriate and to collect the hitherto unpaid tax liability.

In an expanding economy, with a mass of corporate and individual taxpayers, even the most efficient administration cannot undertake to conduct intensive audits of all taxpayers. Nor would this be necessary if all taxpayers were to file complete and honest returns. Assuming a maximum level of voluntary compliance, the tax authorities may limit themselves to examining the more difficult returns, which, because of the interaction of intricate business transactions with the complexities of the tax law, are likely to give rise to substantial tax adjustments.

Taxpayers do not enjoy paying taxes. Neither are they obliged to conduct their affairs so as to produce a maximum liability if lawful alternatives are available under which the liability could be substantially reduced. The Government, on the other hand, is not obliged to accept the consequences of purely formalistic transactions, but it may insist, often successfully, that the transaction be taxed in accordance with its substance, rather than its form. Thus the game of tax avoidance is played, with taxpayers and their advisers constantly on the alert to seek out tax-minimizing devices; while tax administrators and legislators, after having identified such devices, seek to bar them by administrative, judicial or legislative action.

If the administration lacks the capacity to attack tax-avoidance devices vigorously and successfully, the likelihood is that the use of relatively simple and patently transparent devices will increase. Indeed, if the administration is so weak that taxpayers learn to regard it with disdain, they may not even try to cloak their tax-reducing devices with some semblance of reality. They will then ignore the law instead of trying to operate within it. In other words they will engage on a wide scale in tax evasion rather than tax avoidance.

On the other hand, given a vigorous and able administration, taxpayers will tend to resort to more sophisticated tax-avoidance devices. Then, only the criminal hard core or the simple and foolish will seek to evade. And if the administration is supplied with a capable investigative staff and follows a consistent and vigorous criminal prosecution policy, evasion can be held in check. Thus the combined deterrent effect of an adequate audit programme and of serious enforcement measures should help to achieve a satisfactory level of voluntary taxpayer compliance.

The premise that there is a direct correlation between sound tax administration and compliance applies both in domestic and international tax matters. The importance of capable administration cannot be overemphasized. Without it, information from any source, domestic or international, would be wasted.

The manner in which information will be supplied and the extent to which it may be useful are necessarily dependent upon the administrative procedures and applicable laws of the respective jurisdictions. To illustrate the practical problems involved, it is useful to consider the administrative stages through which a potential evasion case will normally pass. These stages, which will be analysed separately, are:

- (a) Identifying a possible fraud situation, such as a potential taxpayer who has failed to report income or a transaction which may be a sham;
- (b) Making an initial determination, based upon whatever information is then available, as to whether a fraud investigation should be instituted;
- (c) Utilizing such authority, procedures and personnel as are available in instituting a fraud investigation;
- (d) If, during the course of investigation, international aspects appear, formulating appropriate requests for information, addressed to the competent authorities of those treaty partners who may be in a position to supply information useful in the case;
- (e) Having gathered all available information from domestic and foreign sources, evaluating the case to determine whether additional tax is owing and whether penal action, by way of administrative penalties, criminal prosecution or both should be undertaken;
- (f) If, after such review, administrative or judicial penal proceedings are to be undertaken and, depending upon the procedural requirements of the particular jurisdiction or jurisdictions, assembling the evidence in the case in a form which would be admissible in the tribunals concerned and which would sustain the validity of the penal action;
- (g) Concurrently or thereafter (depending upon administrative policy in such matters), asserting the appropriate tax liability;
- (h) Collecting the additional tax due, including, if necessary, levy and distraint upon assets of the taxpayer if he is recalcitrant;

(i) Requesting collection information and assistance from other treaty partners if such assistance is provided by treaty.

It will thus be seen that constructing a successful fraud case is an extremely complex, time-consuming and technically demanding process. Countries vary greatly in their policies in respect of the punishment of tax fraud as well as in their administrative structures for carrying out the procedures necessary to prevent or punish such frauds. For purposes of the following analysis of the stages outlined above, it will be assumed that each of the affected treaty partners has a firm policy, supported by law and administrative practice, to enforce its laws strictly against tax evaders.

Identification of possible fraud

Experienced tax officials acquire sensitivity to potential fraud situations. Familiarity with patterns frequently resorted to by cheating taxpayers sensitizes the administrator to circumstances in particular cases which may arouse suspicion. A compendium of frequently resorted to patterns of evasion has been set out in "Simple methods of international income evasion" ST/SG/AC.8/R.20. Routine exchanges of information under double taxation conventions may provide leads to possible evasion, but this is not likely to occur often. The efforts of the administration itself and its ability to identify unusual transactions or taxpayers whose behavior is suspicious will be the most productive of leads to potential evasion. International evasion may be indicated, for example, where a foreign trader or his family take expensive trips abroad or otherwise seem to be living beyond their means. This would suggest that in some way he has managed to divert income abroad.

Initial investigation

If suspicion has been aroused, a preliminary determination must be made whether the case should be diverted from normal assessment channels and specially investigated. This is an administrative decision which depends upon the standards and policy of the administration. The information and factors to be taken into account would not normally, at this stage, require additional information from abroad; nor is it likely that at this initial stage questions addressed to a foreign competent authority could be rationally formulated. It is best to wait for this until the investigation is far advanced and until gaps in the case which might be filled from foreign sources have been clearly delineated. Such forbearance at the initial stage of investigation would prevent needless imposition on the other administration and assure that the necessary information is obtained and supplied with precision.

Instituting a fraud investigation

Assuming that there are sufficient indications of fraud, a special investigation may be undertaken. The procedures available for this purpose may differ from country to country, depending upon the investigative powers of the tax authorities, the procedures which they have established for utilizing available authority and the skills of personnel charged with such investigation. Taking the simple case of the foreign trader who seems to be living beyond his means, this does not yet necessarily imply that he has engaged in international tax evasion.

However, examination of his books may disclose a number of transactions at unrealistic prices with a foreign individual or entity. This may suggest the need for information as to whether the other party is simply the taxpayer's alter ego or some friendly or subservient decoy.

Formulating specific requests for information

If a need appears for information from abroad, the administration should determine whether the only method whereby it could be obtained is through the exchange of information article in a double taxation convention. There are frequently other, perhaps more effective, ways of constructing a provable fraud case. In the simple situation postulated above, it may be possible to rely almost entirely on the net worth and expenditures method. This would not necessarily uncover all assets and expenditures - especially those situated abroad - but sufficient evidence might be available from domestic sources to support penal action. For example, if the taxpayer has no acceptable explanation of where he obtained the funds for an extended trip abroad, and if a supportable estimate can be made of the amount so expended, this, along with other evidence of irregularities, may be sufficient to justify penal action. It may be that the additional information needed from abroad is pertinent not so much for the purpose of establishing that the taxpayer has evaded his liability but, rather, for the purpose of establishing the extent of that evasion. It appears that the latter purpose is also encompassed within the intent of those treaty provisions which limit exchanges of information to fraud and fiscal evasion situations. In more complex patterns of evasion, the proof of the fraud and amount of tax evaded may be more closely intertwined. Whether this is so would depend upon the fruits of the investigation and the extent to which the evasive devices employed can be traced. Even so, the strength of the case may depend more upon evidence garnered from domestic sources than upon information obtained from other countries.

Determining disposition of the case

Few countries have consistent criminal prosecution policies. Fraud, to the extent that it is punishable under the law and administrative practices, may call for imposition of administrative penalties. Under exchange of information provisions which are limited to fraud or fiscal evasion there may be reluctance to comply with requests for information unless there is some degree of assurance that it is seriously intended to penalize the taxpayer, assuming that the information supplied, together with information otherwise available, establishes that the law has been violated. It is not likely that one country will question another's intended use of information requested, but knowledge that the treaty partner has put the requested country to considerable trouble to obtain information which is not fully utilized will deter the requested country from employing its facilities to comply with future requests. Accordingly, it would appear that serious use of exchange of information provisions intended to prevent fraud and fiscal evasion would imply that each of the treaty partners has adopted and utilizes a policy and procedures to punish evaders, as appropriate, by administrative penalties, criminal prosecution or both.

Converting information into admissible evidence

"Information" and "evidence" are not necessarily the same. Depending upon the applicable evidentiary rules, information obtained from foreign sources may have to be obtained in another form in order for it to be useful in a civil or criminal proceeding. The evidentiary rules as to the admissibility of a competent authority report differ widely. Some adjustment of statutory and court rules may be required in order to assure the admissibility in evidence of information obtained under an exchange of information article.

Determining the tax liability

In some countries, if criminal charges are instituted and sustained, the court can impose a fine which is measured by the amount of the tax evaded. This would be in addition to such prison sentence as the court may impose. The prosecutor is therefore obliged to prove not merely that the taxpayer has cheated, but also the exact extent thereof. This would require that information obtained from abroad relate not merely to the scheme, but also to its fruits. In other countries, as in the United States, conviction can be obtained by proving some evasion while the amount of the additional tax liability is left to be determined by subsequent civil administrative and judicial proceedings. The extent and degree of information which might be required from abroad would depend largely upon the burden of proof rules in the particular jurisdiction. If, as in many countries, the taxpayer has the burden of proving that the administrative determination is erroneous, then a best judgment assessment may be sufficient, without being fully detailed. If the burden of proving that the fraud penalty was properly imposed is placed by law upon the administration, this does not necessarily require that the administration assume more of the burden than is necessary to show that the taxpayer has violated the law - without regard to the exact amount. Accordingly, information necessary from a treaty partner to validate an assessment may or may not be greater than that which may be requested in order to institute penal proceedings.

Collecting the tax

Punishing tax evasion is not an end in itself; the ultimate mission of the tax administration is to collect all taxes which are due, in accordance with the law. Tax evaders, even when caught and appropriately punished, often place obstacles in the way of collection of their tax debts.

Collection information and assistance

Recalcitrance may compel the administration to resort to enforcement of statutory liens on the taxpayer's property by way of levy and distraint upon assets which are within the jurisdiction. Where international tax evasion is involved, assets are likely to be located in other countries. Some double taxation conventions have explicit provisions for mutual assistance in collections, although such provisions are frequently limited to situations in which taxpayers may wrongfully seek to obtain benefits under the convention to which they are not entitled. Few conventions provide for relatively unlimited collection assistance: see, for example, the France-United States convention, article 27. Implementation of provisions for mutual assistance in collections necessarily

requires exchanges of information. The requesting country must initially have some reasonable basis for believing that the taxpayer has assets in the requested country. The latter, in turn, may be in a position to supply information (in conformity with its law and procedures) as to the nature, value, location and status of such assets. Close co-ordination between the competent authorities is obviously required. Quick action is also essential because the assets may rapidly be removed to some other country if the taxpayer is alerted.

The matter of mutual assistance in collection merits further study. It is somewhat anomalous that countries should mutually exchange information to assist each other in rooting out tax evasion and determining the proper amount of tax due, while stopping short at the point where they will help each other in compelling the taxpayer to pay the tax. In view of a growing trend toward recognition of the "principle of international law" that one State will not enforce a tax judgment of another State, ^{4/} a reversal of this "principle" may require explicit treaty provisions. On the other hand, in view of some of the rationale supporting this "principle" - such as the possibility that what purports to be a tax may be a confiscation or otherwise a departure from equitable principles - it is understandable that some countries may be reluctant to agree to mutual enforcement of tax liabilities asserted by other countries.

F. Analysis of a common tax-reducing device

Merely to illustrate the difficulties faced by a tax administration in rooting out potential avoidance or evasion, one example will be analysed in some detail. Reference is made to the "Conclusions of country responses on international income tax evasion and avoidance" (S/T/SG/AC.8/R.30, Add.1). It is there stated (pp. 1-2):

"The major problems mentioned by all respondents were dividends and interests. Such income items were often either undisclosed or misrepresented as other income (for instance as loans, fees or commissions, in the case of dividends) for the purpose of avoiding a withholding tax or securing a lower withholding rate."

Tersely, this summarizes many potential tax-avoidance or evasion devices. The analysis which follows will be limited to one of these.

Undercapitalization of companies is a common tax-avoidance device. There may of course be other, non-tax-motivated reasons for entrepreneurs deciding to place a minimum sum at risk as equity capital. In international investment, preference for loans rather than equity investment may be attributable to peculiarities of the laws either of the country from which the investment is emanating or of the country in which it is being invested. The entrepreneurs necessarily balance such considerations along with tax considerations in determining the form in which initial and operating capital should be provided.

The most frequent tax-directed purpose for providing capital in the form of loans rather than as equity is the desire of the entrepreneurs to lay the groundwork

^{4/} See, e.g. United States versus Harden (1963) S. C. R. 366; 41 Dom. L. R. (2d) 721 (Supreme Court of Canada).

for withdrawing future earnings as repayments of loans rather than as taxable dividends. Also, interest paid on such loans would be deductible by the paying corporation as a business expense.

Normally, undercapitalization of a company is considered for tax purposes as tax avoidance, rather than as a tax-evasion device. There are, however, circumstances under which international tax evasion may be involved. Several of these possibilities will now be considered.

The fact that an enterprise is undercapitalized, with the balance of needed funds being supplied by loans, could come to the attention of the tax authorities immediately upon its organization. This would depend upon the extent to which the enterprise is required to furnish complete information with regard to its capital structure in order to obtain authorization to do business and, further, upon the established procedures for making such information readily available to the tax authorities. Even if the tax authorities are not alerted to the undercapitalization at this initial stage, the capital structure, as well as fluctuations therein, would be disclosed by the balance sheets generally required to be submitted in connexion with the annual returns of income.

Aside from their potential use as tax-avoidance devices in respect of dividends and interest, substantial loans may emanate from previously untaxed income. Except in instances of pure speculation, or where a minimum investment is supplemented by public funds to encourage industrial development, the entrepreneurs will have to make available at least the minimum funds needed to assure success. If substantial loans are made by the entrepreneurs themselves, a review of their past income tax returns and net worth statements (if available) may indicate the surfacing of previously untaxed income. This should, of course, be investigated. Loans from third parties may also furnish leads to previously untaxed income.

Realistically, legitimate third-party lenders will require substantial and liquid security, as well as a high rate of return, before making loans to an untested enterprise. If the terms and conditions of the loan depart from what would be considered normal under the circumstances, they may indicate possible tax evasion either by the borrower, the lender or both. ^{5/} A substantial loan by a third party may be legitimate, but it may also indicate that the source is previously undisclosed income of the third party; or the third party may be acting as a front for the entrepreneurs or for someone else. It is reasonable to inquire into the source from which the third party derived the funds from which to make the loan.

Even if the third party is a legitimate lending institution, the real source of the funds may be the entrepreneurs or someone else; and the lending institution may merely be serving as an accommodation front. In order to ascertain this, all of the details of the arrangement with the financing institution would have to be examined. This would raise, in turn, problems of the extent to which bank-secrecy laws insulate transactions with lending institutions from official inquiry. Assuming

^{5/} There may also be private side agreements between the borrower and the lender, giving the latter an undisclosed proprietary interest. Such agreements would lay a foundation for future tax evasion.

no problem in obtaining the details of the transaction, it might turn out that the institutional loan was fully secured by assets acquired by the borrower with previously unreported income. Accordingly, the security for the loan may also be suspected.

Thus far we have considered the possibility that undercapitalization of an enterprise, with needed funds being supplied from substantial loans, may indicate previous or possible future tax evasion by the entrepreneurs or by third parties. Another possibility, worth exploring, is that the accounts falsely record a loan which was in fact never made. 6/ In some way the enterprise may be able to get along without the funds, but the recorded loan would lay the foundation for the later milking of profits, payment of deductible "interest" in lieu of dividends and other false deductions. 7/ The uncovering of such fictitious loans may be more or less difficult, depending upon the ingenuity which the "borrower" used in making them appear to be legitimate. Checking the source of the alleged loan and the manner in which its alleged proceeds were expended would supply useful leads. When faced by an inquiry, the "lender" may deny ever having made such a loan, and the "payees" of the allegedly expended funds may deny having received such payments. In all likelihood, the third parties in such cases, even if they are not themselves fictitious, will know nothing of the transaction; or if they do, they may themselves be parties to the scheme. Accordingly, a fictitious loan once uncovered may provide leads to a string of tax evasions.

Assuming that a loan has in fact been made, the question whether payments of principal and interest should be recognized for tax purposes and not treated as dividends could become a standard tax issue of substance over form. Even if the source of the funds were illegitimate tax-wise, the loan per se would probably have to be recognized as legally valid.

Generally, in attacking the tax status of a loan to an undercapitalized enterprise, the ultimate question is whether what purported to be a loan was in substance an investment of equity capital, subject to all the risks of the business. This is a mixed question of law and fact; and many factors have to be taken into account. The United States Court of Appeals for the Fifth Circuit, which has decided a number of cases involving the debt-equity issue, recently listed 13 relevant criteria, as follows (in re Indian Lake Escates, 448 F. 2d 574, 578-579 (1971)):

- (1) The names given to the certificates evidencing the indebtedness;
- (2) The presence or absence of a maturity date;
- (3) The source of the payments;

6/ The fictitious loan is also often encountered in net-worth investigations. Since a loan is not income, a taxpayer under investigation may seek to obtain a net worth increase as the proceeds of a loan.

7/ For example, fictitious payments or overpayments for depreciable assets would provide a base for excessive deductions for depreciation.

- (4) The right to enforce the payment of principal and interest;
- (5) Participation in management;
- (6) A status equal to or inferior to that of regular corporate creditors;
- (7) The intent of the parties;
- (8) "Thin" or adequate capitalization;
- (9) Identity of interest between creditor and stockholder;
- (10) Payment of interest only out of "dividend" money;
- (11) The ability of the corporation to obtain loans from outside lending institutions;
- (12) The extent to which the initial advances were used to acquire capital assets; and
- (13) The failure of the debtor to pay on the due date or seek a postponement.

If the entrepreneurs had made loans (directly or indirectly) from previously untaxed income, this would probably weigh heavily in favour of ignoring the loan for tax purposes. 8/

The problems of establishing the proper tax treatment of loans to undercapitalized enterprises are, as the foregoing analysis shows, extremely difficult. This is so even if the transaction does not cross international boundaries. A great deal of sensitivity and skill on the part of the tax administration is required to uncover tax evasion and avoidance in the types of transactions here being considered; and even when the administration has sufficient grounds to believe that a transaction is a sham, obtaining the evidence necessary to support administrative action will be most difficult, whether the action proposed is the determination of a deficiency in tax, the imposition of an administrative penalty or the institution of a criminal prosecution.

These problems are compounded when any aspect of the transaction under attack crosses international boundaries. Assuming that, internally, there are no inhibitions upon the ability of the administration to obtain information from locally resident taxpayers, third parties and financial institutions, the authority of the administration generally stops at the country's borders. In potential evasion situations, it can be expected that information (evidence) will have to be obtained by compulsion rather than co-operation. Compulsion can be exercised, if the law permits, upon parties who are physically present. If they are outside the country, they may safely refuse to supply information or they may be insulated from external inquiries by local laws prohibiting disclosure of information of the kind

8/ An interesting side question would be whether the amount of the "loan" or "investment" should be netted to reduce it by the amount of the previously unpaid taxes.

desired. And even if third party sources are willing to co-operate and are not prohibited therefrom, evidentiary problems, particularly in evasion cases, which may go to court become especially acute. There may therefore be no alternative but to rely upon information obtainable under double taxation conventions.

G. Patterns, treaties and evasion

Although some tax-evasion techniques may be characterized as simple (see ST/SG/AC.8/12.20), they are not necessarily engaged in by simpletons. International tax evaders are often very shrewd. Their choice of an evasive device, suitable to the particular transaction, is presumably in accord with their judgement as to its probable success. An important element in this judgment is whether the evasion is likely to be discovered by one or more of the countries whose taxes are being evaded.

The more sophisticated the tax-evasion device, the more likely it is to have an "insulator" somewhere along the line. The insulator may frequently be one or more intermediate countries, through which elements of a transaction may be routed in order to break the trail, both with regard to the transaction and its fruits. The intermediate countries may very well be tax havens, selected because their laws are more lenient, their authorities more friendly and the tax and other fiscal conditions least burdensome. Indeed, if a suitable tax haven is available, the well-planned tax-minimizing device need not even include evasion, but may fall within internationally accepted bounds of tax avoidance.

Take as an example the manufacturer in country A whose product is ultimately to be sold in country C. He wishes to reduce taxes in his home country, and perhaps also establish a hoard of foreign currency. He could resort to blatant tax evasion by falsifying his accounts, using understated invoices and entering into side arrangements with his customers or other co-operating parties in country C. This is, however, too risky. Instead, he establishes (directly or indirectly) an "independent" purchaser in country B, a tax haven. Then, by selling cheaply to the intermediate purchaser, who sells at the regular price to the customer, a substantial part of the profit is diverted to a low-tax area.

This device with numerous embellishments, turns what might have been a white-collar crime into a respectable business venture. One may wonder whether, if tax-havens did not exist, there might not be much more international tax evasion than is now presumed to exist.

The line between tax avoidance and tax evasion is imprecise, and the greedy taxpayer is likely to come so close that he will overstep it. Also, the line may be drawn differently in one country than in another. In the example given above, the tax authorities of country A may suspect that there is something wrong with the pricing arrangement, but they would have to know more about the purchaser in country B, such as who really owned and controlled it, before they could establish this. If country B were well chosen, these efforts could be frustrated, even if there happened to be a double taxation convention between A and B calling for information exchanges. However, complex evasion scheme is more likely to include at least one country which does not have a bilateral agreement with other links in the evasion pattern.

Bilateral conventions, therefore, are useful mainly in dealing with bilateral international tax evasion. Since the clever evader is not likely to resort to "simple" devices, bilateral exchanges of information provisions are an incomplete answer; and they are not helpful to the fullest extent in cases where a relatively simple multilateral evasive device is employed involving three countries. Modifying the example given above slightly, assume that country B is not a tax haven but that the selling agent in country B records a higher cost (supported by false invoices) than the selling price which the taxpayer in country A has recorded in its books. Then, again using false invoices, the sale to the buyer in country C is rigged to evade taxes in that country as well. Assume also that there are bilateral conventions between A and B, A and C, and B and C. In this triangular arrangement, although each of the treaty partners could exchange information between themselves, the secrecy provisions in their respective conventions could prevent any one of them from getting the complete picture of the scheme, even though there has been evasion in each.

In the relatively simple example of multilateral international evasion given above, the secrecy barrier might be broken by a modification of the exchange of information article to permit a country to transmit information received from one treaty partner to another if the latter also has a bilateral convention permitting exchanges of information with the original source of the information. This would be only a partial solution, but still an improvement over present conditions. It would not help if one of the countries involved was an "insulator".

Another possible modification of existing bilateral conventions may be considered. It often happens that the estate of a deceased taxpayer is found to contain cash or other assets which cannot be accounted for except as having been the fruits of income-tax evasion. Assume that countries D and E have both income-tax and estate-tax conventions between them. By the terms of such conventions, information received from country D by the estate-tax authorities in country E, indicating that the income-tax law of country E may have been violated, cannot be transmitted to the income-tax authorities. This compartmentalization of information can, it is suggested, be removed by relatively simple modifications of the exchange of information provisions.

Returning to the matter of multiple international tax evasion, other possible ways to combat it have been suggested. These include multilateral conventions, and the establishment of one or more international tax agencies for the joint investigation of international evasion. These suggestions may provide ultimate solutions to the problem, but it may be that much more experience under existing arrangements will be needed before these additional steps can be taken.

H. Varieties and Uses of Exchangeable Information

Referring again to the directives for this Study (ST/SG/AC.8/R.33), it will be seen that there is a close relationship among the types of information which may be available for exchange, the arrangements and procedures whereby exchanges may be effected and the uses to which such information may be put. These, in turn, are affected by the reality of the need for the information to be exchanged and the anticipated mutuality of advantage to the treaty partners. The rights of affected taxpayers must also be considered for it would be most unfair to supply information which might expose particular taxpayers to inequitable treatment. Underlying the above-mentioned factors is the assessment by each of the treaty partners (expressed or implied) of the capacity of the respective tax administrations to obtain and supply useful information and, conversely, of the ability of each administration to utilize information which may be supplied. These factors may affect the willingness of treaty partners to broaden the scope of exchange of information agreements or their performance thereunder.

With the above as background, we turn to the three main categories of information exchange procedures. These are generally characterized as: (1) routine (or systematic) transmittal; (2) specific requests; and (3) discretionary transmittal. Some aspects of this subject have already been studied in the paper entitled "Information gathering and exchange for income tax purposes" (ST/SG/AC.8/R.20/Add.2) and responses to the questionnaire. Repetition will therefore be avoided here.

Routine transmittal

The underlying conception of a double taxation convention is to define situations in which particular taxpayers, transactions or types of income may be subjected to international double taxation and then to express principles whereby the right to tax is either shared by the treaty partners or vested exclusively in one of them. The characteristic provisions of the OECD Draft Convention, as analysed in this report, indicate the circumstances under which the treaty partners may need information to carry the terms of the Convention into effect.

Initially, if the source country is required by the Convention to apply a different taxing regime to particular taxpayers, transactions or types of income, the request for special treatment under the Convention would have to originate from, or someone acting on behalf of, the affected taxpayer. This would require the filing of some document with the tax authorities of the source country, establishing entitlement to special treatment under the Convention.^{9/} This is particularly the case as to certain types of income which may normally be subject to withholding of tax at the source, such as dividends, interest, royalties and pensions, which may be the subjects of special treatment.

The extent to which complete and accurate information is available to the source country may reflect the general level of taxpayer compliance in that

^{9/} See, e.g. the United States Treasury Regulations under a number of conventions, contained in Code of Federal Regulations, Title 26, parts 500 to 599, revised as of 1 January 1972; and Treasury Regulations, sections 1.1461-1 and 2.

country. If taxpayers generally tend to violate the law with impunity and the tax administration is unable to cope with the situation, alien recipients of income may tend to do likewise. If the latter engage in tax evasion in the source country, they will have little need or desire to supply information which may focus attention upon themselves by the tax authorities in the source country as well as in the home country. Accordingly, if the tax administration in the source country is weak, it is unlikely to possess information which would be useful to its treaty partners. Likewise, an obligation to supply information routinely, automatically or periodically may be difficult to bear.

Consequently, when one speaks of routine transmittal of information it is necessary to assume as a prerequisite a high level of taxpayer compliance in the country which is to assemble the information for its own purposes as well as for its treaty partners. In other words, if the exchange of information is to become routine, it is essential that the procedures for assembling the information can be reduced to a reliable routine. Such information, when collected for periodic (generally annual) transmittal to a treaty partner, could include the names and addresses in the recipient country of persons receiving income from the source country, payors, type of income, amount of income, and amount of tax withheld by the source country. How much of this would be supplied to a treaty partner would depend upon the treaty requirements and the arrangements made between the parties.

Turning then to the recipient country, the key question is whether information thus received periodically and in bulk is desirable or useful. The answer is that it could be, depending upon the procedures applied by the tax administration of the recipient country. Logically, the first step would presumably be to match the names and addresses of the listed taxpayers with the recipient country's register of taxpayers. Those which do not match could be of interest to both treaty partners because they may be persons who may not be entitled to treaty benefits (e.g. residents of some other country) or tax evaders in either or both treaty countries. As to those which do match, the recipient country could find that additional tax is due, or it might wish to inquire into the circumstances which gave rise to the foreign income (e.g. investments of possibly unreported income). In brief, the utility of routinely supplied information would depend upon the procedures established by the recipient country to associate the information with its own files.

There is one form of routine information, not expressly called for by some conventions, which nevertheless seems to be contemplated by all. This is information relating to changes in relevant statutory law, administrative regulations or controlling court decisions. Changes in the domestic tax laws of the contracting States may require changes in the provisions of the convention or in their application. To the extent that such changes may relate to tax evasion, as modifications of investigative powers and procedures or sharpening of the penal provisions, they may affect the circumstances under which the exchange of information provisions may be applied.

Specifically requested information

Even if routinely supplied information may suggest the possibility of tax evasion, considerably more will be required before a case can be built up, successfully prosecuted and the appropriate tax and penalties collected. In the normal course of administering its income tax, a country is likely to have a more

or less complete file on each of its taxpayers. Depending upon local procedures, the file may contain a mass of material accumulated from the taxpayer's first exposure to tax liability, or, by contrast, the only information available may pertain to periods for which liability has not been fully determined or for which collection has not yet been completed.

If a fraud is suspected, a difficult investigation must be undertaken. Its scope and likelihood of success would depend upon the investigative powers available to the tax administration and the skill with which they are exercised. A complete investigation may entail interrogating the taxpayer himself, examining his books and records and obtaining information from third parties, such as business associates, employees, professional advisers, banks and many other sources. If, after a thorough domestic investigation, there are leads to important information which may be available to a treaty partner, then a specific request for exchange of information under a tax convention may be appropriate.

Information from another country may complete the evidence necessary to prove the evasion, determine the correct amount of tax due or both. The State to which the request is addressed is not obliged to supply information of a type which the requesting State could not obtain under its own law and procedures (see discussion of "Some Potential Legal Problems," Post). This implies that the requesting State will have utilized its investigative powers to the fullest before requesting assistance. Indeed, unless it has done so, the probable imprecision of the request for information may suggest to the other State that the request is hardly more than a "fishing expedition". This is not likely to produce the fullest degree of co-operation.

On the other hand, if a full investigation in the requesting country has disclosed significant connexions between the taxpayer and interests in another country, there may be a good possibility that the tax laws of both countries have been evaded, either by the same taxpayer or by others connected with him. Thus a specific request for information may stimulate mutuality of concern in the investigation. Exchanges of information in both directions (a true exchange) would then enable both States to prove their cases fully. This suggests that an enthusiastic response to a request for information is more likely to ensue if the request is accompanied by a full statement of the investigation already conducted and what information is needed.

Discretionary transmittal

Transmittals of information routinely or upon specific request are specifically or impliedly authorized by treaty. A more difficult question arises when, in the course of an investigation, the authorities of one country uncover evidence which suggests or establishes that the tax laws of a treaty partner have been evaded. Should such information be supplied voluntarily to the treaty partner?

If, as suggested at the close of the previous section, there may be a need for information from the treaty partner in order to complete the case, the issue would be avoided. If, however, there is no such need for information, and there is no treaty provision authorizing the voluntary transmittal of information (as is generally the case), then transmittal may be prohibited by the provision commonly found in domestic tax laws compelling the tax authorities to keep tax information confidential.

Undoubtedly, leads which one country may receive from another suggesting theretofore unsuspected tax evasion would be very useful. Nevertheless, tax administrations seem reluctant to volunteer such information. Proposals for treaty provisions expressly compelling transmittal of such information are likely to encounter very little enthusiasm. At best, some may be willing to compromise for a provision authorizing them to transmit such information at their discretion. Although this might override the nondisclosure prohibitions of domestic law, the likelihood of exercise of discretion in such matters would probably depend upon anticipated mutuality. What is suggested is that consideration of a treaty provision authorizing voluntary transmittals of information might better await the accumulation of practical experience under the more standard exchange of information provisions.

I. Costs of Supplying Information

In prior discussions, the matter of the costs incurred in exchanges of information has been raised. An underlying premise of most conventions calling for exchanges of information is that, in the long run, mutuality of exchange will achieve a balance in the costs incurred by both parties. Some reluctance to enter into more extensive agreements relating to exchanges of information may be attributable to expectations by one party that the demands upon it may turn out to be greater than those which it anticipates making from its treaty partner. Other concerns may be whether requests will be limited to truly essential information, whether information will really be used and whether information supplied will produce discriminatory treatment of some taxpayers. This reluctance appears to have been felt most in instances where one of the parties is a developed country and the other is a developing country.

In relative terms, the costs of obtaining and supplying information will probably be greatest for requested information, somewhat less for referred (discretionary) information and least for routine information. Information on request, especially where the subject under investigation is fraud or fiscal evasion, could impose a heavy burden upon the tax administration of the requested country. This would be so even if the request has been formulated with great precision. Fraud investigations must be conducted by officials with the highest degree of skill. No administration has a surplus of such skills. If a request for information is to be promptly and seriously attended to, some other important task will have to be neglected. The cost to a tax administration for diverting some of its best people to matters which may not be productive of revenue to the requested country may be large, but hard to measure. A recompense by the requesting country, in the form of payment for the time of official personnel and other expenses incurred in obtaining and supplying information, might be a mere token. There may, however, be rare instances in which information to be supplied on request will entail direct expenditures, as for outside expert opinions. Such expenditures presumably would be cleared with the requesting country and would preferably be paid directly by that country.

As discussed elsewhere in this report, information supplied by reference is still a relative rarity. This pertains to information which one country has obtained for its own purposes and which indicates that the tax laws of a treaty

partner may have been violated by a particular taxpayer. In this sense, the referring country may be acting as a volunteer or it may have a self-interest, in that by pooling their efforts the two countries may each be able to build a stronger case than the first country could do on its own. Since the information being supplied is already available to the referring country, the element of cost should logically be borne entirely by that country.

The preparation of routinely supplied information may involve an element of cost, but this is likely to be nominal. Such information can be expected to be derived from data already available, and not specially gathered for the benefit of the other treaty partner. Putting it into transmissible form may be largely a mechanical or clerical task. Since the aspect of mutuality is likely to be most pertinent in respect of routine exchanges of information, the balance of cost may be equal or so nearly so that to speak of recompense would not be worth while.

In view of the above analysis, it is clear that the cost factor is pertinent mainly when speaking of exchanges of information on request. It could be that, perhaps unexpressed, the real concern is with disparities between the tax administrations of the treaty partners. It should not be assumed, however, that concern over such disparities is limited to situations involving negotiations between developed and developing countries. The calibre of a tax administration is not necessarily a reflection of the level of economic development of a country. Tax administrations of developed countries are not all on a par; nor is it axiomatic that a developing country need have an underdeveloped tax administration.

To some extent, reluctance to embark on broad exchanges of information may reflect concern that one or the other country may go beyond practical or fair limits in its requests for information. However, to have this concern result in a refusal to enter into any exchange of information at all may deprive each of the parties of exactly the information needed to perfect a particular case.

The practical answer to the problem of cost of information exchanges seems to lie, as has been found in connexion with other problems, in raising the standards of tax administration in all countries. One gets the impression that the administrations which are least certain of themselves are the ones which are most anxious to receive information from other countries. Contrarywise, as suggested before, the strongest administrations, having possession of, or being capable of, assembling such information, seem concerned about supplying information to administrations which either are unable to put it to full use or which may use such information inequitably as against certain classes of taxpayers. On the other hand, weak tax administrations seem to attract international tax evaders, and if so, other countries may desire to obtain information to aid enforcement of their own laws. However, given the possibility that information may be desired from a country having a weak tax administration, the requesting country may still doubt the efficacy and utility of information which it might receive.

Pending the time when measures taken either unilaterally or on an international scale may raise the level of tax administrations so that the principle of mutuality would govern in matters of exchanges of information, some interim solutions may be desirable. Depending upon the law and procedures of the respective treaty partners, it may be possible to alleviate some of the problems of cost of obtaining information by permitting officials of the requesting country to obtain the information themselves. This could be done, to assure compliance

with the procedures of the requested country, under the supervision or with the assistance of officials of the requested country. If this is feasible, it would not only save direct and indirect costs of the requested country, but would also assure the requesting country that the information obtained is usable, both in substance and form.

Periodic discussions, preferably on a multilateral basis, among officials who are concerned with requesting or supplying information also seem desirable. Such discussions would serve the practical purpose of testing out procedures employed by particular countries and would have the effect, where necessary, of helping those countries in need to learn from the experience and practices of others.

In summary, the question of costs of supplying information, although a serious one, need not be avoided by simply declining to enter into commitments for the supply of information. All countries will require information from others at some time. The real question is whether the cost may be expected to balance out in the long run. This is a matter of gauging expectations as to whether information is likely to flow only in one direction and whether it is really necessary and useful. As suggested, this may be a problem of improving tax administrations rather than one of costs.

III. EXCHANGE OF INFORMATION AND INTERNATIONAL TAX EVASION AND AVOIDANCE (INDIA)*

A. Introduction

The fiscal instrument has now come to be recognized as an effective tool in channeling the resources of a country in the best interest of the community, combining a balanced economic growth with social justice. When taxation has to play such a vital role, avoiding or evading taxes can no longer be looked upon as a battle of wits between the individual and the State, but has to be considered as an attempt on the part of a few well-to-do persons to escape their duties and obligations to the society at large. The need to combat tax evasion and tax avoidance therefore has special significance in the present-day context.

With the imposition of economic and monetary discipline in most countries, both developed and developing, economic offences have come to the forefront as a challenge to the authority of the State. Smuggling of scarce and valuable commodities, or commodities which are prohibited by law in the interest of the well-being of the community, is a very common economic offence, which both the advanced and the less advanced countries have to deal with. The developing countries have, in addition, their own special problems. The need for rapid and planned economic development necessitates certain restrictions in trade, industrialization, foreign exchange and so on. At the same time, it also necessitates working in partnership with the more developed countries and accepting their assistance, particularly in the technical field. This has thrown the door open to various types of manipulations and racketeering, such as smuggling of gold and luxury articles, illegal imports and exports, under-invoicing and over-invoicing of exports and imports, illegal transactions resulting in drainage of foreign exchange resources and so on. It is a curious paradox of the situation in most developing countries that while money for worth-while investments and public purposes is in short supply, there is a great deal of unaccounted money circulating in their economies in search of further undercover gains. The social evil inherent in tax evasion is doubly compounded as it leads to a greater tax burden on those who are law-abiding, thus shaking the confidence of the honest taxpayer in the ability of the tax administration to combat tax evasion.

The developed countries have also come to realize their responsibility to ensure a better living for the poorer sections of the people, not merely as a matter of philanthropy, but as a measure of practical wisdom for the sake of stability and peace in the world. The laudable objective of the developed countries in extending a helping hand to the developing countries gets thwarted by tax evaders and other racketeers. As pointed out by a member at the third meeting of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing

* In the preparation of this chapter, the United Nations Secretariat had the assistance of Ramanlal D. Shah, Chairman, Central Board of Direct Taxes, New Delhi, India, who acted as consultant.

Countries, the loss of tax revenue, and in particular foreign exchange, suffered by developing countries is often of major proportions even in relation to the foreign aid which they receive. International tax evasion does not really benefit the richer nations either. It benefits only a few individual racketeers. The world community as a whole only suffers, and honest citizens have to bear a heavier burden to enable their Governments to maintain their countries' contribution to international development. International tax evasion does not always mean evasion of the high taxes usually prevailing in the developing countries; often tax evasion in the developed countries also follows as a corollary. For instance, undisclosed commissions which are secretly received in developed countries for circumventing the foreign exchange regulations of developing countries might, if detected, be taxable in the developed countries. Often the money concealed in the developed countries is used for illegal purposes or for financing clandestine business deals, and the Governments of developed countries have a common interest in co-operating with developing countries for coping with tax evasion and other economic offences having international ramifications. Combating international tax evasion and other economic offences is therefore equally important to both developed and developing countries, and it would be to their mutual advantage if the economic depredation involved therein was stopped.

Tax evasion is closely linked to all the other types of economic offences and helps to increase their area and extent. Even where tax evasion is not the primary object, it is a natural corollary of every form of economic offence. No measures to counteract the various economic offences can succeed unless the problem of tax evasion, particularly that of international tax evasion, is effectively handled simultaneously. Tax evasion thrives on lack of information and the consequent inability of the governmental machinery to act promptly. The first and foremost step in developing an efficient set-up for coping with tax evasion should therefore be to provide smooth and fast channels for securing reliable information having a bearing on tax evasion and other economic offences.

B. Modes of tax evasion or avoidance

In most cases the modus operandi of tax evasion is well known. But difficulties arise when an attempt is made to take the case from the realm of suspicion to that of proof. Getting together adequate documentary and other evidence to clinch a charge of tax evasion or other economic offence is not easy. The task is difficult enough even when the tax evader and the field of his operations are within the country and the entire machinery and full authority of the Government are both available for commandeering the evidence needed to prove evasion. This task becomes all the more difficult, in many cases even impossible, when territorial barriers intervene. Thus, in a case where letters rogatory were issued to the concerned authority in a foreign country to secure from a person resident therein certain evidence for establishing tax fraud, it was held that the tax officer requesting information was not a court, and as such the evidence could not be secured on his behalf.

In another case, extensive under-invoicing of jute goods exports was noticed. The documents seized disclosed the existence of a secret running account of the taxpayer with the foreign importer to which the amounts under-invoiced were found credited. The documents also indicated the existence of a relationship of agent and principal between the foreigner and the taxpayer. The taxpayer, however,

claimed that the foreigner was not his agent, but an independent operator acting at arm's length and that the transactions were all on a principal-to-principal basis. According to him, the running account with the foreigner merely represented certain mutual claims, and eventually the credits and debits in the account got squared up automatically and no amount was liable to be repatriated to the home country of the exporter. In the absence of authoritative evidence relating to transactions in the foreign country, the charge of any substantive violation of foreign exchange regulations could not be established, and the violation, if any, was held to be merely technical or formal. In the same case, considerable difficulty was experienced in proving under-invoicing for the purpose of the taxpayer's income-tax assessment in the absence of authoritative information relating to the price pattern of jute goods in the foreign country and the practices prevailing in that trade.

In the case of an exporter of shellac, duplicate invoices in respect of the same consignments showing different amounts were seized. The taxpayer explained that the second set of invoices, which were not produced before the customs and other authorities were "consular invoices" made out at the specific request of the foreign importers for purposes not known to the taxpayer and that the invoices for the lower amounts which were produced before the customs authorities showed the correct prices and were acted upon in reality. While there was strong suspicion of collusion between the taxpayer and the foreign importer, the charge of under-invoicing could not be substantiated in the absence of material evidence from the foreign country.

In the same case it appeared that the exports were effected through two dummy associates in the foreign country, which performed no services whatsoever but pocketed a sizable chunk of the profits. Orders were received directly from the ultimate buyers, and shipments were also effected directly to them and the role of the two intervening associates was very nebulous. It was explained in very general terms that the foreign associates made market survey, developed contacts, booked orders and so on. These claims could not be disproved in the absence of positive evidence of their role or activities in the foreign country.

A common method of avoiding or evading taxes is through the medium of foreign subsidiaries and holding companies. Very often such foreign affiliates are nothing but sham concerns with no real business purpose or functions and are interposed between two genuine ends of a transaction merely for the purpose of reducing the taxable profits. The profits are reduced by unrealistic sale or purchase prices in transactions between a domestic company and its foreign affiliates. At times the taxable profits are sought to be reduced by an improper allocation of head-office expenses to the foreign branches. Though certain provisions exist in the law almost of every country to deal with cases of tax avoidance through closely connected foreign associates, the application of such provisions is fraught with difficulties, and it is not possible to sustain action thereunder in the absence of conclusive evidence from the foreign country.

Similar arrangements help a foreign operator avoid his proper tax liability by setting up some dummy concerns either in his home country or in third countries. All business is channelled in such a way through these dummies that the foreigner ostensibly makes no profit in the country of import. It is not possible to trace these intermediaries and establish that they are dummies unless evidence can be secured from the foreign country where they claim to operate.

Importers of capital equipment from abroad very often manage to get the goods over-invoiced, the difference being paid to them secretly in the foreign country. Such arrangements act against national interests in two ways. They help to secrete foreign exchange abroad to be utilized for vacationing or financing illegal deals. They also boost up the capital cost of the equipment, which is ultimately written off against revenue by way of capital allowances in different forms, thus resulting in tax evasion as well. Cases of this nature cannot be proved beyond doubt in a manner acceptable to courts and other appellate authorities unless it is possible to secure evidence from foreign countries.

Secret bank accounts abroad are another medium through which tax evasion and foreign exchange violations thrive, taking advantage of the territorial barriers and absence of channels of information between the countries involved. Only an effective arrangement for exchange of vital information between different countries can discourage such underground activities or bring them to the surface whenever they do take place.

An importer of a well-known make of foreign typewriter was suspected of having an account in the foreign country to which the foreign exchange earned illegally by him and kept outside his books was believed to have been credited. When investigations started, there were indications that these monies were surreptitiously transferred to a secret account in another foreign country. Though the suspicion was very strong, such secret dealings could not be proved in the absence of authoritative information channels from the foreign countries concerned.

In another case, an exporter of iron ore was suspected of shipping higher grades of ore against lower specifications to importers in a foreign country. Invoices were made out for lower grades at lower prices, and it was believed that the difference was being secretly received and retained abroad. The ore analysis reports before shipment also appeared to have been manipulated. It was known that the ore had been subjected to fresh analysis at destination in the foreign country. If it had been possible to obtain the reports of analysis done at destination, under-invoicing could have been proved beyond doubt. As this was not possible, and as the taxpayer himself did not produce these reports, the allegations could not be sustained.

Countless instances can be cited to show how facilities for obtaining prompt information from foreign countries would be of great avail in making proper tax assessments. In a recent case, a person living abroad had died leaving a will in favour of his nephew. A copy of the will was no doubt produced before the tax officer. However, it was noticed that while the properties in the home country were listed in detail, properties held abroad were not so listed. By a clause in the will, the residue of the testator's property, movable and immovable, wheresoever situated, was bequeathed in favour of his nephew absolutely. It was believed that the deceased had extensive business and property abroad. As the will was said to have been probated abroad, efforts are being made to obtain the information from the foreign country concerned, but resorting to diplomatic channels invariably involves considerable loss of valuable time, which in many cases is the essence of investigation. A treaty provision with the country concerned for the exchange of information would have greatly facilitated obtaining the required information.

C. Patterns of provision for exchange of information

The need for international co-operation in combating tax evasion is now widely recognized and finds expression in the many tax treaties which both the developed and the developing countries have been entering into among themselves. A salient feature of all such treaties is a clause relating to exchange of fiscal information between the contracting countries. Historically, these conventions developed with the primary objective of avoiding international double taxation, and the information exchange clause in these agreements naturally restricted itself in the initial stages to information necessary for the purpose of carrying out the provisions of the agreement. Some countries, including India, continue to have such restricted tax avoidance agreements only, while others have developed them into comprehensive tax treaties covering not merely the avoidance of double taxation, but assistance in the matter of investigation of tax frauds and recovery of taxes. The OECD Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital 1/ goes a modest step further than the conventional agreements for the avoidance of double taxation, and article 26 provides for exchange of information as is necessary not merely for the carrying out of the convention, but also of the domestic laws of the contracting States concerning taxes covered by the Convention. This enlargement of the scope of the treaty provision would facilitate exchange of information, which is so essential for making proper assessments of the tax liability of persons deriving income from sources in either or both the contracting States. In practice, while some countries have adopted verbatim article 26 of the OECD Draft Convention, others have made minor changes or significant departures therefrom. In some of the agreements, the rules of article 26 of the Model Convention have altogether been omitted. 2/ Certain treaties do not require exchange of information for the purpose of carrying out the domestic laws of the contracting States, 3/ while others have made an additional provision for the exchange of information designed to prevent fraud or avoidance of taxes. 4/ Under some treaties, the Government of one of the contracting States is required to supply information only upon the specific request of the other Government and not as a matter of routine. 5/ One convention even provides that the contracting States shall not supply information concerning their own nationals and enterprises other than what is necessary to establish reduced rates or exemptions in connexion with the treaty provisions in reference to "permanent establishments" 6/ Some treaties specifically include courts and administrative tribunals among the government agencies to which information obtained from the other treaty country may be disclosed. 7/ Some conventions include rules on mutual administrative assistance in the collection of taxes. 8/

1/ Organisation for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital (Paris, 1963), p. 36.

2/ India-Pakistan, France-Japan, Sweden-Switzerland.

3/ Austria-India.

4/ Austria-Finland, Germany-United Kingdom.

5/ Germany-Canada, France-Switzerland.

6/ Belgium-France.

7/ Austria-United Kingdom-Canada.

8/ France-Germany.

Article 26 of the OECD Draft Convention, however, does not include such rules. Some countries have entered into agreements mainly for reciprocal administrative assistance in the matter of levy and collection of taxes. 9/ Some of them include provisions for procurement and exchange of information required for the assessment and collection of the levies covered by the agreement. 10/

D. India's tax agreements

India has entered into tax agreements with 15 countries. Basically these are agreements for avoidance of double taxation only. In fact, until recently, the Indian law envisaged only such limited agreements, and section 90 of the I. T. Act, 1961, before its amendment in 1972, authorized the Central Government to enter into agreements with foreign Governments for granting relief in respect of double taxation and for avoidance of double taxation only. With certain variations, the article on exchange of information in these agreements provides for exchange of such information, being information which is at the disposal of the contracting States under the respective tax laws in the normal course of administration, as is necessary for carrying out the provisions of the agreement. The earliest of such agreements was with Pakistan, which does not include any clause for exchange of information. Some of India's agreements are limited in scope, covering particular operations only, such as air transport. Such limited agreements ordinarily do not have any information exchange clause. Some of the more recent agreements which India has entered into with other countries provide for exchange of information, not only for carrying out the convention, but also the domestic laws of the contracting States concerning taxes covered by the conventions. 11/ The disclosure of information under India's tax agreements is ordinarily restricted to the authority concerned with the assessment or collection of taxes. But two recent agreements elaborate the term "assistance" to include judicial determination, thus providing for disclosure of information to appellate authorities as well. 12/ However, broadly speaking, India's tax agreements do not go much beyond the limited scope envisaged in article 26 of the OECD Draft Convention and basically remain mere double-tax avoidance agreements.

E. Need for broad-based provision for exchange of information

One of the most challenging problems in the administration of international taxation is the prevention of fiscal evasion through transactions with persons in another sovereign jurisdiction. The problem of checking such avoidance or evasion assumes greater magnitude because of the fact that the authorities are under severe limitation, both by jurisdictional and practical considerations to reviewing only one side of the transaction. Solutions to such problems have to be

9/ Germany-Hungary.

10/ Denmark-Sweden.

11/ India-United Arab Republic (now designated as Egypt).

12/ India-Romania.

developed by statute or treaty provisions for mutual exchange of information and other forms of administrative assistance. The Canadian Royal Commission on Taxation, studying the problem of international tax avoidance, observed that much can be gained from the fullest exchange of information under Canada's tax treaties and proposed certain administrative changes that would facilitate such exchange. The Commission recommended the development of special groups in the Department of Finance and the Department of National Revenue to serve inter alia in reducing causes and instances of international tax avoidance and in increasing co-operation with the tax authorities in other countries. Included in the functions of the group in the Department of National Revenue proposed by the Commission are drafting taxpayer reporting requirements so that information can be obtained in the most useful form for assessment purposes, and applying special matching and investigation procedures to certain tax returns and information. 13/ The report entitled Tax Reform Planning - Taxation, Mobilization of Resources and Income Distribution in Developed Countries (E/4988 and Corr.1, para. 208) has, while examining the need for a concerted and integrated approach to tax reform planning, stressed the importance of the development of an information system. The Expert Group stressed the urgency of training in the verification of tax returns, tax audit, investigation and so on, and recommended that the over-all programme should include exchange of information. 14/

From the point of view of developing countries, a treaty provision requiring exchange of fiscal information has special significance. It has been stated that such a provision may be the most valuable contribution a convention can make to the tax effort of a developing country. 15/ As mentioned earlier, the drainage of resources resulting from international tax evasion and other forms of economic depredations is from the developing countries in the direction of the more developed countries. Authoritative information regarding the operations of their own citizens in foreign countries and their foreign links and associates alone can help developing countries to stop such leakage of scarce resources. Apart from contributing to the improvement of their tax revenues by checking evasion and avoidance through various artifices, this would also be invaluable in preventing other economic offences such as smuggling, under-invoicing and over-invoicing of imports and exports, irregular transactions in currency and foreign exchange, and so on. Facilities for exchange of information will also in effect place at the disposal of a tax official in a developing country the often superior investigative facilities available in a developed country. It is therefore necessary that developing countries should broad-base their tax treaties, particularly the clause relating to exchange of information, so as to ensure that their resources are not siphoned off and their development programmes are not nullified by the manipulations of a few self-seekers.

13/ Report of the Royal Commission on Taxation, vol. 4, p. 564.

14/ Tax Reform Planning (United Nations publication, Sales No.: E.71.XVI.1).

15/ Foreign Investment in Developing Countries (United Nations publication, Sales No.: E.68.II.D 2), para. 98.

F. Scope for amplifying provisions for exchange of information

Some of the tax treaties between developing and developed countries already provide for exchange of information to carry out the convention and the domestic laws of the contracting States concerning taxes covered by the conventions. The provision needs to be amplified to cover prevention of fiscal evasion. In fact even "tax avoidance" should be brought within the scope of the clause, as there is considerable leakage of tax revenue because of various artificial arrangements involving shifting of income from one country to another or to "tax havens". The type of information and the manner in which it is to be exchanged also need to be broad-based. There need be no restriction that the contracting States would supply information only upon the request of the other Government. Information should be exchanged as a matter of routine as well as on specific request. Information relating to the tax laws of the contracting countries, general market information and prevalent trade practices should be exchanged on a routine basis. Information relating to payment of income by persons in one country to the residents or citizens of the other country should also be exchanged on a routine basis. However, as observed by the Canadian Royal Commission on Taxation, receipt and processing of information in mass would not automatically provide an effective solution to the problem of tax avoidance in connexion with international transactions; it would be necessary to select from the mass particular operations for further examination and, where indicated, close scrutiny. ^{16/} It will therefore also be necessary to obtain specific information in individual cases on request.

At the third meeting of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, ^{17/} fears were expressed that automatic exchange of information between Governments would not be advisable because of the resulting communication of a mass of irrelevant data. However, often, a specific request for information cannot be made unless there is ground for suspicion. Information exchanged on a routine basis is likely to provide such ground. Further, automatic exchange of information will have considerable potential as a deterrent. It should not be difficult to evolve procedures by which the information to be exchanged on a routine basis is restricted to manageable proportions and is put to meaningful processing and fruitful inquiry.

There is yet another type of information exchange which does not fall under either of these two categories. Often the tax officials of a country, in the course of investigation, come across evidence which could be of help to foreign countries in detecting and establishing tax frauds committed by their residents. Neither exchange of information on a routine basis nor supply of information on specific request will be of help in such a situation. Provision will therefore need to be made to enable a country to pass on such information to the other country.

^{16/} Report of the Royal Commission on Taxation, vol. 4, p. 565.

^{17/} Tax Treaties between Developed and Developing Countries: Third Report (United Nations publication, Sales No.: E.72.XVI.4).

A comprehensive programme of information exchange should therefore include:

(a) Automatic exchange of information on a routine basis covering information relating to such transactions as may be agreed upon, market information and texts of tax laws;

(b) Supply, on request, of specific information relating to individual cases; and

(c) Voluntary transmission of information obtained in individual cases by one country to the tax administration of another country to whom such information might be of assistance.

Tax treaties should also include rules on mutual administrative assistance in the collection of taxes and checking of fiscal evasion and avoidance so as to ensure that the information exchanged is utilized in achieving the objective of checking international evasion and avoidance.

Most of the present conventions prohibit disclosure of information obtained to authorities other than those responsible for the assessment and collection of taxes. It is necessary to relax this restriction so as to facilitate disclosure of the information to courts and administrative tribunals. If penal convictions for fraud are to be sustained, the disclosure of such information to criminal courts cannot be avoided. The scope of the disclosure provision must therefore be widened in the interest of effectively combating tax evasion. While it is necessary that the contracting States should be under an obligation to treat as secret information which is received under the exchange clauses in their tax treaties, there is no reason why the secrecy provisions should be so restrictive as to interfere with effective steps being taken for countering tax evasion and other economic frauds. Protection need primarily be given only in respect of trade, business, industrial, commercial or professional secrets or trade processes.

G. Steps taken by India for broad-basing tax treaties

India has realized the importance of having broad-based comprehensive tax treaties with the countries with which it has a substantial volume of trade and is also intimately connected in various economic co-operation programmes. To facilitate the conclusion of broad-based conventions, section 90 of the Income Tax Act, 1961, and the corresponding provisions in the other direct tax laws have been amended recently by the Finance Act, 1972, to enable the Central Government to enter into agreements with foreign countries not only for the purposes of avoidance of double taxation of income, wealth and the like, but also for enabling the taxation authorities to exchange information for the prevention of evasion or avoidance of tax or for investigation of cases of such evasion or avoidance, or for recovery of taxes in foreign countries on a reciprocal basis. Realizing the importance of such conventions and for securing the requisite specialization, the Government of India have also set up a Foreign Tax Division in the Ministry of Finance to deal with cases of foreigners, foreign enterprises and Indian enterprises having foreign collaboration. These steps are expected to pave the way for broader-based treaties with foreign countries and initiation of reciprocal administrative assistance programmes in combating evasion and collecting taxes. The existing law in India itself provides for the collection of a wide

variety of information from and concerning the taxpayers in India. Section 206 of the Income Tax Act, 1961, requires every person paying taxable salary to furnish a prescribed return giving details of the payment and the payee. Sections 285 and 286 make it obligatory for persons paying interest or dividends in excess of the prescribed amounts to furnish statutory returns giving full information regarding such payments. Section 285A provides for furnishing of information by contractors in certain cases. These provisions ensure a steady flow, more or less automatically, of a variety of information relating to payment of income. Apart from this, there are other provisions in the law which enable the tax officials in India to secure vital information regarding transactions having a bearing on tax liability. The income tax officers also have the power of survey and of search and seizures, which provides them with information relating to tax evasion and fraud. Hitherto the collation and compilation of the information has been manual. Recently India has decided to allot permanent account numbers to all its taxpayers, which will eventually facilitate processing of information by computers. India will therefore be in a position to furnish a wide variety of fiscal information to any contracting country on a reciprocal basis.

H. Problems connected with exchange of information

No doubt, before any effective arrangements can be made for the exchange of vital fiscal information and for mutual administrative assistance in fighting tax evasion and avoidance, several administrative problems will have to be solved. Often there is wide divergence between the laws of different countries in the matter of securing information. It will not obviously be possible for a contracting country to furnish information which is not obtainable under its law in the normal course of administration. Nor would it be fair for it to seek more far-reaching information from another country than what it would be authorized to request from its own nationals. There has to be some sort of uniformity in the type of information available with the contracting countries before a workable exchange programme can be drawn up. It would be helpful if all countries are made aware of the need to introduce pertinent legislation so as to have statutory authority to obtain the same kind of fiscal information. Similarly, there may be divergence in the administrative powers of the tax officials in the contracting States as a result of which one country may not be able to carry out administrative measures which the other can, as these might be at variance with the laws and administrative practices of the other country. Exchange of information obtained from banks and similar institutions pose another major problem. Most countries would like to ensure secrecy of banking operations since otherwise public confidence in the banking system might be shaken. Procedures will therefore have to be evolved whereby information about bank transactions can be exchanged only in cases of suspected tax fraud. It is relevant to mention here that the Swiss Federal Tribunal, the highest court of Switzerland, held that the Swiss authorities were bound to furnish information regarding the bank account of a United States national to the Internal Revenue Service of the United States of America under the terms of the tax treaty between the two countries. Where there is specific agreement between two countries to exchange such information, the bank secrecy laws, if any, of the contracting countries should not be allowed to get in the way. There could also be divergence in the laws of the contracting countries relating to secrecy of information obtained in the course of tax proceedings. Some countries have stringent secrecy provisions. In others, the provisions are not so restrictive. The clause relating to exchange of information will have to take due cognizance of such variations.

Another problem that might arise is the matter of sharing of administrative cost. The problem is not insurmountable, and the treaties can provide as to how and in what circumstances the country seeking information would have to pay for the administrative cost incurred by the other country in procuring the information. Ordinarily, in the case of a routine exchange of information, the question of sharing of cost should not arise at all. The exchange should be automatic and free of cost in respect of items of information agreed to be exchanged without specific request by the contracting countries. Each country should bear its own expenses in procuring and furnishing such routine information. The same should hold for exchange of market information or trade practices and information relating to the tax laws of the contracting countries. However, where specific information is sought in individual cases, it might be necessary to insert a clause for charging the administrative cost to the country seeking the information so as to discourage indiscriminate calling of unimportant information in individual cases. Similarly, where any expert evidence is sought by one country from the other, there should be a provision for charging the country seeking such evidence the cost of securing the same.

I. Administrative pattern for exchange of information

Once the international community decides to pool together all information and intelligence necessary for fighting international tax evasion, it will be necessary to set up an administrative machinery which will provide smooth and fast channels for exchange of information. Article 25 of the OECD Draft Convention permits the competent authorities of the contracting States to communicate directly with each other without the necessity of resorting to diplomatic channels, or to arrange for an oral exchange of opinions through a commission consisting of representatives of the contracting States. While it is no doubt necessary to eliminate the need to resort to diplomatic channels for this purpose, even the procedure of direct exchange may not be effective or efficient once the volume and variety of information to be exchanged increases beyond a certain point. Better results can be obtained if a contracting country has its own resident revenue representatives in other countries with which it has extensive investment and trade relations. The Internal Revenue Service of the United States of America has an office of international operations in key foreign areas entrusted with the work of exchanging information, collecting taxes and providing taxpayer education and assistance to its won citizens resident abroad. If countries which agree to exchange fiscal information set up similar organizations in each others' territory, they could be useful in channelling the information collected more effectively and promptly. In India the study team appointed by the Government to examine the problem of leakage of foreign exchange through over-invoicing and under-invoicing of imports and exports has stressed the importance of developing intelligence by cultivating contracts on a planned and systematic basis in places where the requisite information and intelligence is likely to be secured. The Committee has recommended that officers should be posted at important centres abroad to ensure better inflow of commercial intelligence and valuable data, and that these officers could also constitute the nucleus around which the necessary intelligence network could be built up for securing secret information of the type required for dealing with under-invoicing and over-invoicing. A single organization might be set up with specialist wings for securing, processing and transmitting information, whether general or specific, having a bearing on the administration of the foreign exchange regulations, the customs law and the direct tax laws. This organization could work in close liaison with investment centres, trade representatives and missions abroad. Apart from acting as channels for exchange of information, such an organization can play

several other useful roles. It could advise nationals of the country residing abroad and foreigners having investment or trade connexion in the country with regard to their liability and obligations under the tax laws of the country represented. It could also assist them in discharging their obligations. It could further act as adviser on matters relating to economic and investment problems having international implications. It could assist in enforcement programmes involving investigation of fiscal evasion or recovery of taxes from foreign residents. It could also assist in verifying the bona fide financial and technical resources and tax status of foreign residents in connexion with collaboration agreements or global tenders.

J. Apprehensions of flight of capital

At the third meeting of the Ad Hoc Group of Experts on Tax Treaties, fears were expressed that too liberal provisions for exchange of fiscal information might divert international investment to countries which do not have such arrangements. ^{18/} Apprehensions of flight of international capital following agreements providing for exchange of information seem to be somewhat exaggerated. What the developing countries are interested in is investment and technical assistance by established and well-known foreign investors. One need not, therefore, be too pessimistic about any adverse consequences of liberal exchange of information on the economy, particularly of the developing countries. Already several developed countries have agreements to exchange information for fighting fiscal evasion. Tax evasion and other economic offences harm both the developing and developed countries equally, and there is no reason why they should be reluctant to come together to make a joint effort to combat this evil.

K. Problems of tax havens

As pointed out by the Special Adviser to the Rapporteur at the third meeting of the Group of Experts, the problem of tax havens has to be considered under two different aspects, namely, the situation of a country which is used against its will as a tax haven and that of a country which desires this status. ^{19/} Today, there are very few countries which are tax havens in the real sense of being totally free from taxes on income. But as different countries have varied tax structures with wide-ranging levels of taxation, human ingenuity has found methods of arranging international transactions in such a way as to shift a taxable event from the tax jurisdiction of one State, where it would be subjected to a high tax, to that of another State, where it would not be a taxable event at all or at any rate would be subjected to a comparatively low tax. Often the letter of the law is strained considerably to achieve this result and a legally valid form is given to transactions which are in substance unreal or sham. Not infrequently, even facts are given a twist by furnishing incorrect or inconsistent information to the tax authorities of different countries so as to derive undue benefit under their tax laws. It is in this area that an efficient machinery for exchange of information could be of immense help. First-hand knowledge of the tax laws of other countries would help tax authorities to be alert

^{18/} Ibid., para. 163.

^{19/} Ibid., para. 152.

to the problem of deliberate attempts at shifting tax jurisdiction. Authoritative information relating to the claims made by the taxpayer in another country would help in the detection of incorrect or inconsistent claims. A comprehensive programme of exchange of information would to a great extent take the edge off the problem of tax avoidance or evasion through tax havens and thus supplement the countermeasures which the affected Governments have to adopt in dealing with it.

IV. EXCHANGE OF INFORMATION AND INTERNATIONAL TAX EVASION AND AVOIDANCE (MEXICO)*

A. Tax problems resulting from payments to enterprises abroad

Nowadays, relations between countries at different levels of economic development give rise to disputes which carry over into the field of tax relations, where legal regulations give expression, usually belatedly, to each country's concern for defending and promoting its own economy and for applying to capital coming from abroad or being sent abroad the even-handed treatment which it merits from the standpoint of the proportionate contribution it ought to make to the defrayal of public expenses in the various countries.

Certainly, problems of the kind discussed in this chapter are not new in the field of taxation law. They are usually insignificant in the case of relations between persons carrying on business in the same country or in countries at the same level of development whose trade is in balance. However, traditional treatment, which is fair when applied to such relations, is unfair and gives rise to abuses when applied to relations between persons in countries at different levels of development.

It is true that the United Nations has taken note of this kind of problem and, as regards at least one aspect, namely treaties for the avoidance of double taxation, has promoted a new approach based on a recognition of the difference in economic levels of States which may have to consider concluding such treaties. Until now such treaties, however complex in their technical structure, have not created inequities when concluded between developed countries, the aggregate concessions granted not being too important inasmuch as reciprocity serves to equalize the economic effects.

However, treaties based on reciprocity have proved unsatisfactory when one contracting party is a developed State and the other a developing State, and for that reason the need to devise a new model which would take existing inequities fairly into account has been recognized.

In their reciprocal relations as sovereign entities, countries can and do strive to establish fair legal norms which take into account the similarity or dissimilarity of their respective situations and, because there is a belief in the ability of States to attain this ideal, the efforts of the international community to subject its relations to the principles of law have been and will be productive.

However, although it is reasonable to hope that States may put logic before expediency and justice before self-interest, there is no reason to be equally optimistic in the case, not of States, but of individuals motivated simply by economic gain who operate in difficult countries in search of maximum profit.

* In the preparation of this chapter, the United Nations Secretariat had the assistance of Robert Hcoy, Commissioner of Taxation, Mexico, who acted as a consultant.

The very same free enterprise, freedom to set market prices and unrestricted recognition of private property which have been protected and encouraged at home by so many countries become, when projected into international markets, instruments of exploitation and of steady flows of wealth progressively enriching the rich countries and impoverishing the weaker countries.

It should not surprise anyone that countries which, having first struggled for their political emancipation, are trying to buttress it with economic independence and for that purpose are striving to raise the social and economic level of the masses of their population, should feel forced to nationalize, expropriate and in various ways promote the acquisition and control by their own nationals of the natural resources and basic activities connected with the production of goods and services, and that they should do so even at the cost of the grave consequences of reprisals, in particular, of decisions on whether the investments of private persons of one country in the enterprises and activities of another are to be maintained, increased or withdrawn.

The developing countries would not be so strongly "nationalistic" and foreign property would not be so threatened, if it were possible to ensure that enterprises operating at the international level could reciprocate for the profits they derive from their activities in poor countries with fair wage, price and tax-paying policies.

If these objectives are to be achieved even to the admittedly limited extent that is possible through proper tax treatment, it is necessary to pin-point the problems which result from payments between private persons of different countries.

The Mexican tax administration was invited by the Inter-American Center of Tax Administrators (CIAT) to submit at its Fifth General Assembly, held at Rio de Janeiro, Brazil, in May 1972, a paper entitled "Tax evasion resulting from payments made abroad: the situation in Mexico".

This chapter similarly discusses problems resulting from:

1. Overpricing or underpricing in relations between enterprises of different countries.
2. Payments for transfer of technology between such enterprises, involving:
 - (a) Royalties for the use of patents or industrial processes;
 - (b) Royalties for the use of trade names or trade marks;
 - (c) Payment for technical assistance provided by foreign enterprises.
3. Interest derived from financing operations between enterprises.

These problems are not particularly difficult to solve when the payments are made between enterprises which are not only legally but also economically independent of each other; but tax treatment which is suitable in such cases becomes inequitable when applied to relations between enterprises which, although legally independent, actually constitute a single concern. The difficulty in making firm decisions lies in the fact that it is impossible, or possible only to a limited degree, to distinguish one situation from the other.

B. Overpricing or underpricing in relations between enterprises of different countries

Developing countries customarily purchase machinery, equipment and a wide variety of consumer goods which they are unable to produce economically from the developed countries. The only sure way to make such purchases is by exporting goods which can be placed on foreign markets, usually raw materials obtained from agriculture, livestock-rearing, mining and other primary activities. Exports of manufactured goods by such countries are kept down by high production costs, which themselves are due to limited domestic markets that make it impossible to produce in the volume required to reduce prices to internationally competitive levels.

A steady decline in prices for raw material exports and a constant increase in the cost of acquiring capital goods and consumer goods are strangling the weaker countries and making them cry out for fair prices for their products as a means of halting their gradual impoverishment. If the present trend continues, these countries will be left so drained that large potential markets which the more developed countries might have fostered and benefited from will be lost to them.

These are problems which lie outside the purview of tax agreements, but they become more acute when large international enterprises set up establishments, whether in the form of subsidiaries or branches, in the less developed countries and, for the purpose of escaping tax, simulate prices higher or lower than the fair or even the true prices.

The free sale of goods by the enterprise of one country to the enterprise of another country should normally produce a certain profit for both enterprises which could legitimately be subjected to the domestic taxation of the States concerned; but if the enterprises are interdependent, they could manipulate prices in such a way as to artificially increase the profit of the enterprise resident in the country where the tax burden is lighter, which is usually the less developed one. Theoretically, that country would benefit because more profits would accrue there, but this is not actually the case since such relations also involve another subsidiary of the same international enterprise resident in some third country which, by virtue of its tax system, has come to be known as a "tax haven".

If an international enterprise decides to take advantage of the facilities and even the sacrifices of a developing country by establishing, say, a factory there, it is apparently not content with the profit it gains from lower taxes, lower labour costs, proximity to supplies of raw materials and easy access to the market of the country in which the factory is established. If the factory needs goods or products from the parent company, they are not purchased directly but through the enterprise established in the tax haven, which buys them from the parent company at the normal price and supplies them at more than the true price. Conversely, when the factory has to send its products to the parent company or to the international market, again it does not do so directly but utilizes the subsidiary in the tax haven, with which it contracts to sell at prices lower than the true prices and which, in turn, resells the products at normal prices. In both operations the profit accrues to the establishment situated in the tax haven.

Contrary to what is generally believed, tax havens do no harm to the treasuries of developed countries. Either those countries have legal instruments capable of counteracting the effects of such devious transactions by compelling

the parent companies to combine their operations and those of their subsidiaries for income tax purposes, or they look the other way, tolerating such arrangements as a means of providing hidden subsidies for their exports.

In a tax haven, there is no income tax on the profits of resident enterprises so long as the goods in which they trade have not entered its territory. The only advantage to such States (and one which is disproportionate to the harm they cause) is that part of the profits artificially produced in the manner described above is retained in their banks.

Developing countries which trade with developed countries are the ones that suffer the harmful consequences of such arrangements, which make their imports more costly, reduce their export profits and deprive them of the tax benefits which they should receive from an equitable attribution of profits.

These developing countries try to defend themselves against the kind of arrangement described above by taking unilateral measures. For example, their authorities often have the right to adjust for tax purposes the prices at which resident enterprises buy or sell goods internationally, whenever they deviate from the true market prices.

Under Mexican taxation law it is possible, for the purpose of determining an enterprise's taxable income, to specify prices at variance with what appears in its books and even with what is shown in the relevant documents. Article 19, section VI (b), of the Income Tax Act states that taxable income shall be deemed to include "the difference between the prices declared by the taxpayer and those specified by the Ministry of Finance and Public Credit, whenever prices declared do not correspond to true market prices. In such cases, the Ministry shall, for the purposes of this Act, specify the prices, taking into account the invoice price, official prices and prevailing price on the domestic or foreign market." As regards deductions for the purpose of determining taxable income, it is laid down that "whenever the purchase price declared by the taxpayer in respect of imported goods does not correspond to true market prices, the Ministry of Finance and Public Credit shall specify the price, taking into account the invoice price, official prices or prevailing prices on the domestic or foreign market".

Thus, the necessary legal instruments do exist to prevent enterprises resident in Mexico from pretending to have sold goods abroad at less than the true prices or to have made purchases at prices higher than the normal ones. However, there are many products which have no international price or whose international price is difficult to determine exactly; again, the manipulation may involve other cost components - for example, freight charges in the case of an international enterprise which is also engaged in the transport business. Moreover, specifying national prices for purposes of domestic taxation might have an unfair effect on normal price mechanisms if, owing to special although perfectly legitimate circumstances, the prices differ from the normal levels on the international market. For these reasons, the Mexican tax administration has not, for the past 10 years, exercised its statutory power to specify a national income from sales or to adjust the purchase cost of goods from abroad.

If, as it appears, the efforts of the developing countries are not sufficient to counteract these operations, and if it is unreasonable to expect that the developed countries will take the necessary corrective action, the only solution seems to be to encourage, through international co-operation, the elimination of "tax havens".

C. Payments for transfer of technology between enterprises
of different countries

Royalties for the use of patents and various technological processes

The modern world is founded on science and technology, which hold great promise for the life and well-being of all peoples. Those countries which have devoted a large part of their resources to scientific development for peaceful purposes have acted wisely and well, and they deserve the gratitude of the whole world.

Private enterprise has not failed to play a part in scientific advancement; on the contrary, by sponsoring various types of research, it has contributed decisively to the furthering of ideas and techniques which have made possible the mass production of new and constantly improving amenities.

However, in the hands of private enterprise, the results of research become a capital asset capable of generating profits. When they are exploited by other enterprises, royalties must be paid for the use of patents or various technological processes both in industry and, although to a lesser degree, in commerce.

If an enterprise has invested in scientific research and receives a financial return in the form of royalties, there can be no objection.

A country's domestic tax treatment of royalties paid by some of its enterprises to others presents no problem, because what is a deduction for one enterprise is income for another.

Where such transactions take place between enterprises of different countries, what was a simple matter under the domestic system of one country becomes complicated when one of them is the country of residence of the enterprises making the payments and the other is the country in which the enterprises receiving the income are situated.

In such cases, the State in whose territory the enterprises receiving royalties are resident considers that it has a legitimate right to tax the royalties, since they usually result from, or are received in compensation for, expenditure, the deduction of which has affected the amount of tax paid by the enterprise concerned. Furthermore, such royalties unquestionably form part of the recipient's income and thus constitute, together with other items of income, the financial means from which income tax may be levied.

Sometimes, however, the countries from which the royalty payments emanate take the view that the source of the income is within their territory, because it is there that the industrial or commercial activities made possible by or carried out with the technological assistance in question are performed. They therefore feel justified in taxing the income represented by the royalties, even when they are paid to enterprises resident abroad.

There are various ways in which double taxation can be avoided. One method is a unilateral concession by the country of residence of the recipient of the royalties, allowing as a credit against the income tax payable by the enterprise at its place of residence the amount of the tax it has paid in the country which is

the source of the royalties. Another way of avoiding dual taxes is, of course, through treaties for the avoidance of double taxation.

When no such treaties exist or when, as often happens, the State whose residents receive royalties limits the amount of the tax credit or erects so many administrative obstacles that it is difficult to obtain in practice, a recipient enterprise which knows that its technical assistance is vital to the enterprise paying the royalties may specify in its contract that the payer of the royalties must in addition pay, for its own account, any income tax to which the royalties may give rise in the source country. This creates the paradoxical situation that enterprises paying royalties may deduct the relevant expenditure for income tax purposes but, at the same time, must pay their own country's income tax on the income derived by an enterprise abroad, so that what should be a tax on income is in fact converted into a tax on expenditure.

The situation becomes even worse when the country of the recipient of the royalties allows credit for taxes paid abroad even where the financial burden was borne not by the enterprise receiving the royalties, but by the enterprise which paid them.

Consideration should be given to appropriate forms of tax treatment in countries whose enterprises pay royalties. Traditionally and as a matter of course, the payment of royalties has been regarded as a normal, legitimate and unavoidable business expense. Therefore, for income tax purposes, royalties may be deducted in calculating the taxable base. There would appear to be nothing wrong with this, provided that the amount paid out in royalties is not disproportionate to the business conducted by the enterprise.

Taxes on income in respect of royalties paid to enterprises abroad could be minimal and might even be abolished, since it cannot be to the advantage of the economically less developed countries to increase the production costs of their own residents. However, taxes on a scale similar to or higher than that for taxes on profits are often imposed on such income because it is suspected and frequently proves to be true that royalties serve merely as a device for siphoning off profits.

These problems might be solved by means of an equitable determination of the amount of royalties paid by enterprises to other enterprises; however, there are obvious dangers in making a subjective judgement as to when royalties are a normal and unavoidable expense and when they are merely a device for siphoning off profits. The best approach might be for the amount paid in royalties by enterprises which import technology to be proportionate to their profits instead of depending on their income from sales. Unfortunately, the solution is in the hands of private enterprises and not of States, which could persuade their residents only indirectly, through their tax incentive policies, not to acquire technology except on the basis of profits.

The only true radical solution is for States aiming at development to make the greatest efforts to build up their own technology by giving private enterprises the fullest incentives and also by allocating some of their public resources to the development and promotion of research.

Royalties for the use of trade marks or trade names

Separate mention should be made of payments between enterprises of different countries, still under the heading of royalties, but for the use of trade marks and trade names. In these cases, there is every reason for the State of which the enterprise receiving the income is a resident to treat it as part of its taxable income. However, the treasury of the country of which the enterprise making the payment is a resident should review the hitherto widespread practice of allowing as a deduction the amount of such payments. Today, the so-called "prestige" of a trade name or trade mark is nothing more than the result of investing resources in the use of mass publicity media in order to impress on the minds of consumers a familiarity with a given product and the desire to purchase it.

No matter how widely used a product may be in one country, if it is unfamiliar in another it will have no "prestige" whatsoever there unless a similar familiarity is created through the use of the appropriate publicity media. And if the cost of publicity is also to be deductible for income tax purposes, as it usually is, the related royalty is either a second payment made for the same purpose or an expenditure which is not needed in order to obtain the income, so that it should not be allowed as a deduction.

Payment for technical assistance provided by foreign enterprises

Because of the need for technology from more developed countries, Mexico has tried to find favourable methods of tax treatment for income derived by non-resident enterprises in the form of payments for technical assistance services rendered by them.

Initially, income derived by non-residents in respect of technical assistance was regarded as an incidental commercial transaction; the taxable income was estimated to be 20 per cent of the gross income and the rate applied was also 20 per cent, so that the final levy amounted to 4 per cent of the payment for technical assistance.

It was soon found that this favourable 4 per cent rate (as opposed to the considerably higher rates at which enterprises were normally taxed) was leading foreign companies to make use of supposed payments for technical assistance, which in fact were payments of royalties, in order to siphon off profits from enterprises in Mexico without their having borne the tax that was payable on an enterprise's taxable income.

For that reason, the 4 per cent rate referred to above was raised first to 10 per cent, then to 20 per cent and finally, under the reform which came into effect on 1 January of this year, to 42 per cent, which is the same as the maximum rate of taxation on royalties and on the profits of resident enterprises, thus doing away with rate differentials according to the type of income received, which constituted an open invitation to the evasion of Mexican taxes.

A year earlier, on 1 January 1969, another reform of the Income Tax Act had gone into effect, making it a condition for a tax deduction that "in the case of payments to persons resident abroad for technical assistance, proof must be submitted to the Ministry of Finance and Public Credit that the party providing such assistance possesses the technical facilities to provide it, that it is

furnished directly and not through a third party, and that services are actually provided and not merely made available". The reasons for this reform, the problems experienced by the tax administration in detecting spurious technical assistance and the outcome of its efforts are described in the paper submitted at the Fifth Assembly of CIAT, to which the reader is referred in order to avoid needless repetition.

It should be added that, in the course of the discussion of that paper at CIAT, it became clear that the other Latin American countries had problems similar to those experienced in Mexico, and that international enterprises in some of them had taken the precaution, which in Mexico had been overlooked, of maintaining large collections of instructions and other printed matter to make it appear that enterprises paying for technical assistance were actually receiving a wide range of services from abroad.

The Mexican tax administration hopes that the action taken to bring the rates of tax on payments for technical assistance into line with those for royalties and profits and the requirements laid down for taking deductions in respect of technical assistance will prove to be effective in combating this kind of evasion, which some writers on the subject insist on referring to as "lawful" and which in fact is simply the result of fraudulent pretences.

D. Interest from financing operations between enterprises

Mexico, like other Latin American countries, is striving to promote domestic savings and investment, but in order to accelerate its development it needs capital from abroad. Foreign investment is welcomed in Mexico and, while no concessions are made for it, there are also no discriminatory measures against it, although care is taken to see that it complements rather than replaces actual or potential investments of Mexican capital.

However, in order to encourage domestic savings, very favourable tax treatment has been accorded to income from investments, whether the capital invested comes from the savings of Mexican nationals or originates abroad.

Thus, interest from what are known in Mexico as "fixed income" securities (debentures, bonds, mortgages, financial certificates and bonds and other securities issued in series by credit institutions) is subject to very favourable treatment in Mexico. If the yield is less than 7 per cent, no tax is payable. Interest of 8 per cent is taxed at the rate of 2 per cent, 9 per cent interest at 3 per cent, 10 per cent interest at 4 per cent, and so on until the rate of taxation reaches 10 per cent.

When such interest is received by individuals (natural persons), it is taxed only at the proportional rates indicated above, irrespective of the amount received, and the income is not aggregated for the purpose of determining the total personal tax. However, when such interest is received by companies, it must be aggregated for the purpose of determining taxable income.

Interest received by private persons in Mexico from credit institutions is liable only to the proportional tax of 10 per cent, and in the case of individuals the income is not aggregated with other income.

Interest paid to banks abroad is likewise liable only to a proportional tax of 10 per cent and is not subject to a progressive scale. In such cases, the foreign bank is regarded as a tax subject in Mexico because the source of the income which the interest represents is deemed to be in Mexican territory.

The favourable treatment of interest has already caused serious distortions in the financial structure of enterprises in Mexico, since it results in their being constituted with a relatively small capital, the rest of their funds being obtained through indebtedness, frequently towards their own shareholders or domestic or foreign creditors.

Under the traditional income tax system, the interest which a company must pay on its borrowings are an unquestionable expenditure to enable it to have the use of outside capital, and such interest is therefore recognized as a deductible expense.

Thus, it is more attractive to constitute an enterprise with little capital and high liabilities, since interest is deductible and therefore results in taxation only at a rate of from 2 to 10 per cent depending on the type of liability assumed by the company, instead of at the company tax rate of 42 per cent.

This situation is currently under review by the Mexican Government with an eye to requiring income received by individuals in the form of interest to be aggregated for the purpose of determining their taxable income, despite the difficulties involved owing to the fact that the securities in question are bearer securities. From the opposite angle, consideration is being given to the advisability of limiting the amount of interest which may be deducted where an enterprise's liabilities exceed its capital by more than a given proportion.

While it is true that the problems mentioned above do not concern foreign investment in Mexico, they become even more serious when the same favourable treatment of income in the form of interest is accorded to foreign enterprises or investors.

The point is that a foreign enterprise may open a subsidiary in Mexico with a small amount of capital supplemented with credit granted by a foreign bank, the interest on which is taxed at a rate of only 10 per cent in Mexico, even though the subsidiary is able to save 42 per cent of its tax by deducting that interest from its taxable income. For this reason, enterprises constituted with foreign capital also make excessive use of borrowing, thus reducing their taxable base and increasing their income by virtue of the fact that the interest they pay is subject to reduced proportional rates.

Mexico has no desire to discriminate against investments of foreign capital in the matter of taxation; however, the relationship between parent companies and their subsidiaries becomes a matter of particular concern when the parent companies take unfair advantage of the favourable tax treatment of interest from securities in order to reduce the tax burden on the subsidiaries.

In conclusion, all that can be said on these subjects in the case of Mexico is that there is now an awareness of the distortions caused by the favourable treatment accorded to interest from capital investments (in that no limit is placed on the amount of interest which enterprises are allowed to deduct and the income of

the recipients of such interest is taxed at reduced proportional rates); that this results in an unfair distribution of the tax burden; and that these undesirable consequences ensue in the case of both Mexican and foreign investments. These problems are of immediate concern to the Mexican Government, although no legislative solutions have as yet been applied.

It seems unnecessary to set out any general conclusions from this chapter, since, as regards each subject dealt with in it, the problem has been pin-pointed and the broad solution considered necessary has been outlined.

It might be said, however, as an expression of a broader aspiration which would encompass the individual matters of concern referred to in this paper, that enterprises of developed countries which establish subsidiaries, make investments or carry on other business in less developed countries must pay their fair share of taxes in those countries, according to the nature of their business and the size of their income, without resorting to endless manipulations - only the most commonly employed of which have been outlined here - whose purpose is to reduce, by means of legal trickery and book-keeping stratagems, the already limited tax income of the countries where they are obtaining profits.

V. EXCHANGE OF INFORMATION AND INTERNATIONAL TAX EVASION AND AVOIDANCE (GHANA)*

Liability to pay tax in Ghana is imposed on income of all types accruing in, derived from, brought into, or received in Ghana. Where the receipt is in respect of land or any natural resources situated in Ghana, then the income is chargeable to tax irrespective of where the transaction from which it arose was made or whether the receipt was in or outside Ghana. 1/ The income tax legislation is based primarily on the source principle. Thus as a general rule, residents in Ghana do not have to pay tax on income accruing or derived from outside Ghana unless such income is brought into or received in Ghana. Further, there is no tax levied by virtue of mere citizenship. Non-residents are subject to tax in the same manner as residents. They are liable to tax on all income earned or derived from domestic sources in Ghana. Practically the same rules govern the determination of their taxable income, and the progressive rates apply equally to the non-resident as to the resident tax payer. 2/ Prior to the 1967/1968 tax year, non-residents paid tax at higher rates than residents. This bias has now been removed. But the present equal treatment is subject to the proviso that the resulting tax paid by a non-resident must not be less than 30 per cent of his total income earned in Ghana.

Companies wholly owned by Ghanaians with chargeable income not exceeding ₵ (cedis) 20,000 are taxed at special graduated rates; otherwise the non-resident corporation pays tax at the same rate as the resident company. Companies licensed to manufacture under the Excise Ordinance, 1953 (No. 31) pay 50 per cent in income retained in Ghana and 57.5 per cent on income not so retained. All other companies pay 55 per cent on income retained in Ghana. Any portion of their

* In the preparation of this chapter, the United Nations Secretariat had the assistance of A. N. E. Amissah, Judge, Court of Appeal, Accra, Ghana, who acted as a consultant.

1/ Income Tax Decree, 1966 (N.L.C.D.78), para. 5.

2/ The rates for the resident taxpayer are as follows:

<u>Chargeable income</u>			<u>Rate of tax (percentage)</u>
First ₵	400	at	Nil
Next ₵	140	"	5
" ₵	480	"	7 1/2
" ₵	480	"	10
" ₵	960	"	12 1/2
" ₵	960	"	15
" ₵	960	"	20
" ₵	1,200	"	25
" ₵	2,400	"	35
" ₵	2,400	"	45
" ₵	4,020	"	60
Exceeding ₵	14,400	"	70

(₵ = \$US 0.77)

taxable profits not retained in Ghana, however, attracts tax at 62.5 per cent (prior to the 1968/1969 tax year it was 70 per cent). 3/

The present Ghana tax system makes no distinction between the different types of income. Interest, royalties, dividends and business income of all kinds incur tax at the same rates, except that in the case of dividends there is a withholding tax of 55 per cent.

Because of the economic conditions of the country, company laws and tax system some of the recognized methods of international tax evasion are not known in Ghana. For example, as the law regulating companies requires that a share certificate must include the name and address of the registered holder, 4/ bearer shares cannot be issued within the country. Further the Income Tax Decree provides that:

"Every company which is resident in Ghana shall deduct from the amount of any dividend paid or payable to any shareholder tax at the rate or rates paid or payable by the company, on the assessed income of the year of assessment within which the dividend is declared payable." 5/

This tax withheld being almost always higher than the individual taxpayer's effective rate, the shareholder will forfeit his credit by non-declaration of his dividends. Foreign source income of residents kept abroad attracts no tax in Ghana; therefore the use of bearer shares issued by enterprises situated abroad does not make much difference to the position of the resident taxpayer. For the same reason, namely, that foreign source income kept abroad is not taxable in this country, Ghana residents do not feel the need to use the device of holding companies located in foreign countries to receive income directly or indirectly accruing to them from sources outside the country. But they do use the facilities of various foreign banks for this purpose. That, however, under the present law amounts to an avoidance and not an evasion of Ghana tax.

To a large extent the claim that tax evasion is widespread in Ghana is based on suspicion rather than concrete cases. The records of the tax authorities are not rich in cases indicating volume or illustrating methods adopted in international tax evasion. The enforcement section of the tax administration, being young and inadequately staffed, is under such high pressure to keep abreast with evasion within the confines of the country that evasion cutting across international frontiers has taken an extremely low position in its order of priorities. But examples occur from time to time of situations bound to involve income tax evasion so that the suspicion assumes more solid dimensions. Such evasion may not be the primary objective of the party in question. But that intention cannot be totally excluded, even in the cases pointing most blatantly to a different objective. It is difficult to believe that the tax aspect of

3/ See Income Tax (Amendment) Decree, 1969 (N.L.C.D.377), para. 4, amending the fifth schedule of N.L.C.D.78.

4/ The Companies Code, 1973 (Act 179), s.53(1).

5/ N.L.C.D.78 16(1).

the exercise escapes the attention of the hard-headed businessman who often indulges in these practices. In any case, whatever the intention, the net result is a loss of tax revenue which would otherwise accrue to the State. Some of these practices will be discussed below.

In this paper it is proposed to deal with the problem of international income tax evasion under two heads: (a) methods of evasion and avoidance and (b) control of evasion through exchange of information.

A. Methods of international tax evasion and avoidance

Since foreign source income is not subject to Ghana tax until it is remitted to Ghana, the predominant pattern of avoiding Ghana tax is for the resident to keep his foreign income in foreign banks instead of remitting it to Ghana. The dominant factor which seems to influence the reluctance of residents to repatriate their foreign source income is not the tax benefit involved, but rather the desire to circumvent the prevailing stringent foreign exchange regulations. What begins as an act of avoidance, however, often turns into outright evasion when a substantial part of the income is brought into Ghana in the form of well-sought-after commodities with high profit margins like second-hand motor cars and ladies' wigs, paid for abroad with the foreign exchange acquired from the foreign source income. Another common form by which such undeclared income is constructively remitted to Ghana is the illegal sale of cheques drawn on foreign bank accounts to persons who require foreign currency. By these methods the income is effectively remitted to Ghana; it is undeclared as income and therefore bears no income tax. Yet it is received in Ghana in the most profit-yielding form. The Government has, in an effort to check these practices, recently introduced a measure whereby importers who desire no foreign exchange to pay for their goods will have to state how they were able to pay for the goods in the country of origin. Even so it does not appear as if this measure is fool-proof.

As indicated, some of the methods of tax evasion by residents occur with an intention primarily directed toward the avoidance of exchange controls. This pattern seems to occur in other fields, for other forms of evasion have come to light through investigations not directly connected with tax. An example of evasion through the control of a subsidiary by its foreign parent emerged from an inquiry into subsidies which had previously been given by a government marketing board to the subsidiary. The company in Ghana was a subsidiary of an international organization dealing in cocoa, Ghana's main export crop. It was engaged in the conversion of cocoa into cocoa butter, liquor and cake for export. Being concerned with a commodity of such vital interest to the economy, the Government consented to an agreement whereby the company bought its cocoa from the Cocoa Marketing Board at a discount. The company for years never made any profits in spite of the high world cocoa price then prevailing, so it paid no tax for those years. When the question of continuing the favourable buying arrangement came up for consideration, the company's accounts were looked at for the first time by the Government. It was only then that the discovery was made that it made no profits because all its products were exported to the parent company which paid only milling charges determined by that parent abroad. By this time the subsidiary in Ghana had received £1,285,950 by way of subsidy for its cocoa purchases, and further had paid a paltry sum by way of tax on the odd freak year when their accounts disclosed a marginal profit. The real profits on the subsidiary's operations were made by the

principal. If the tax legislation of the country of residence of the overseas company is such that no tax is paid on the profits of its subsidiaries abroad, as is possible, then the principal pays no tax either.

Some forms of income tax evasion appear from manipulations in connexion with indirect taxation. For example a person or an organization which has established a factory for the manufacture of goods depending on raw materials imported from abroad, imports finished or semi-finished products under the guise of raw materials. Often the co-operation of some customs officials is necessary to allow this misdescription to go through successfully. Shoes have come into Ghana as raw leather. It is suspected that broken-down parts of cars ready for assembly have also come in as spare parts. The importer gains the advantage of paying the usually lower duty on raw materials or spares as opposed to the higher duty on the finished product. Usually this is the obvious infringement of the law that is noticed. But the operation may have a bearing on direct taxation because the offender may go for the double stake of securing an advantage from income tax as well in that his returns for tax purposes will show a deduction of the normal expenses, which he has not incurred anyway for the manufacture of the goods in Ghana.

Inflation of invoices for imports is a common feature of business practice. It has led to a recent scathing public attack by the Head of State, Colonel I. K. Acheampong, on businessmen indulging in this practice. ^{6/} A random examination of only 22 invoices in March 1972 showed increases in prices ranging from 15 per cent on a consignment of refined sugar, to the extraordinary figure of over 1,600 per cent on drugs. Drugs seem to be a favourite item for large percentage inflations because the next highest, that of over 200 per cent by a totally different company, was also on drugs. Most of the increases were in the range of 30 to 50 per cent, involving diverse products like motor graders, compass sets, tyres and tubes, spare parts for machinery, food items and again drugs. Heavy losses were made by the country on payments for motor trucks even though they carried a percentage inflation of 17.6. Assuming a modest average over-invoicing of 30 per cent, the toll on the country that this practice exacts is tremendous. To make the inflation worth while the importer must have an arrangement with the supplier to pay the difference either in whole or part, on a sharing basis, into a foreign bank account. The ideal is the branch office or subsidiary importing from a parent supplier abroad. The differences are kept wholly within the family. The drug cases mentioned earlier illustrate this point nicely, the suppliers being the principals of the importers in Ghana. The practice appears so far to have attracted the attention of the authorities from the exchange control angle or its tendency to impose exorbitant prices on the consumer. But its incidence on direct taxes should not be lost sight of. An even more ambitious scheme, but one yielding gains from three different fronts, is the use of two sets of import invoices; one with lower figures for the customs authorities, and the other with higher figures for the exchange control and income tax authorities. The culprit profits from lower customs duties, lower income taxation and manages to get his money fraudulently out of the country in the bargain.

A concomitant practice is under-declaration in export invoices. It is known that domestic exporters of primary products like timber and a variety of food-stuffs

^{6/} See report in the Ghanaian Times and the Daily Graphic of 23 May 1972.

declare lower prices than the amounts realized from their exports on their export invoices. Again, the collusion of the foreign importer is necessary so that the difference between the actual and fictitious prices may be paid over or shared. Such income by the exporter usually finds its way into a foreign bank account.

A decree of 23 May 1972 makes it an offence to transfer money illegally out of the country by wilful misrepresentation. The illegal transferor is liable to the payment of 10 times the amount so transferred within a time limited by the Court recording a conviction. The penalty is payable in foreign exchange. If the penalty is not paid within the time allowed, the defaulter is liable to a fine of £10,000 or imprisonment of not less than 5 years or more than 15 years or both. 7/ This measure, together with stricter verification of import and export invoices, should help to reduce the number of incidents of this nature.

Tax revenue is lost as a result of overstatement of foreign expenses by non-resident enterprises and resident enterprises controlled by non-residents. No real problem seems to arise at present with regard to the domestic enterprises which operate abroad, for the simple reason that the number of domestic enterprises which so operate is very small.

It is generally believed that non-resident taxpayers and resident taxpayers controlled by non-resident principals overstate the cost of services rendered abroad with a view to either reducing the taxable income of their subsidiaries generally or allocating higher profits to subsidiaries operating in countries with lower tax rates. The dispute in this respect arises between the tax authorities and the taxpayer over the basis of allocating these so-called headquarters expenses (e.g. staff salaries, rents and similar items) among a number of subsidiary or group enterprises which operate in different countries. Since it is not easy to verify these "overseas expenses", the Income Tax Decree, 1966, provides a general remedy in the following terms:

"In the case of a company operating in Ghana which is a branch or subsidiary or associated company of a non-resident company, the profit for the period deemed to arise in connection with the operations of that company shall be computed by reference to the total consolidated profits of the whole group (including both the resident and non-resident companies), taking into account the proportion which the turnover of that company bears to the total consolidated turnover of the group." 8/

With regard to individuals or sole proprietorships, the Decree provides that:

"Where a non-resident person carries on business with a resident person, and it appears to the Commissioner that, owing to the close connection between the resident person and the non-resident person and to the substantial control exercised by the non-resident person over the resident person, the course of business between these persons can be so arranged and is so arranged that the business done by the resident person in pursuance of his connection with the non-resident person produces to the resident person

7/ See Foreign Exchange (Amendment) Decree, 1972 (N.R.C.D.69) ss.4, 5 and 6.

8/ N.L.C.D.78, s.6(1) (b).

either no profits or less than the ordinary profits which might be expected to arise from that business, the non-resident person shall be assessable and chargeable to tax in the name of the resident person as if the resident person were an agent of the non-resident person." 9/

Under this provision, the case of the Ghana subsidiary whose prices were determined by its foreign parent mentioned earlier could be dealt with.

It is not unknown for foreign suppliers to supply second-hand equipment for new. The profit margin is much higher than that actually declared; this leads to a diminution of revenue arising from the transaction.

In the speech made by Colonel Acheampong referred to earlier, he mentioned information reaching the Government that local agents of foreign companies were paid commissions in foreign exchange which when paid abroad deprives the authorities in Ghana from getting their share in taxes.

Then, of course, there is the perennial problem of non-filing of returns or filing of inaccurate returns. In a developing country, where the idea of a tax on income is relatively new, and was in any case first introduced by a colonial administration, where illiteracy is high and the tax administration is such that the incidence of taxation affects a much smaller section of the community than that envisaged by the law, there is not the same developed social conscience about the payment of income tax or performance of duties connected with it as there is in more developed countries. The filing of returns is widely avoided. And this applies not only to illiterate persons with taxable income, but also to the well-educated. It extends to some members of the foreign business community who in their own countries would behave differently.

Recently a dispute arose as to whether Ghana's national airline should pay taxes on the income allegedly derived from its operations in one developed country over the past five to six years. Out came the discovery that the national airline of that country, which had been operating in Ghana for over 10 years, had not only paid no tax for the period but had never filed a single return. Of course that airline now claims that it never made any profits from its operations in Ghana, the sole object of its commencing operations there being the altruistic one of furthering a development project of importance to Ghana.

Measures have been taken against non-filing of returns. A provision of the tax law by which failure to file returns within two months of the commencement of the year of assessment, in the case of an individual, or four months of the end of its financial year in the case of a company, constitutes an offence and imposes a penalty of a fine of ₵240 or imprisonment for one year. 10/

9/ N.L.C.D.78, s.31(2).

10/ Income Tax Decree 1966 (N.L.C.D.78), para. 71; see also para. 38 of N.L.C.D.78.

In a wide range of trading, business, professional or vocational activities, provision has been made for annual registration with the Commissioner of Income Tax and the payment of a prescribed fee before the person is allowed to participate for the year. 11/ The activities include areas where non-Ghanaians also operate, e.g. building contractor, architect in private practice, engineer in private practice, accountant in private practice, 12/ and therefore may involve a non-resident principal. Further, a number of persons, not including companies, are subject to standard assessments. The assessments, which are graduated in some cases, are quite high and constitute an estimate of a rate of tax somewhat higher than that which the person assessed may have to bear ordinarily. For example, the accountant in private practice is assessed at ₵500 per annum if he has been in private practice for 3 years, ₵1,000 per annum if more than 3 but less than 6 years and ₵2,400 if his practice exceeds 6 years. 13/ This in turn compels him to file his returns if he considers that his payable tax ought to be less. The usual offences in respect of incorrect returns made without reasonable excuse carry a penalty of a fine and double the amount of tax undercharged in consequence of the incorrect return. 14/ False statements and returns made knowingly or wilfully for the purpose of reduction of tax 15/ carry a penalty of a heavier fine and treble the amount of tax for which the offender is liable for the year of assessment in respect of which the offence was committed.

By law, it is impossible to obtain a number of licences or permits or have services performed or claims met without the production of a tax clearance certificate showing that the person has paid his income tax for the year or made satisfactory arrangements with the tax authorities for its payment. A non-Ghanaian may not leave Ghana without a tax clearance certificate. Foreign exchange for travel and now for foreign business transactions may not be obtained without it. The registration of deeds concerning land, grant of a permit to build, receipt of moneys under an insurance policy and many more require a tax clearance certificate. 16/

11/ Income Tax Decree 1966 (N.L.C.D.78), para. 81.

12/ N.L.C.D.78, sixth schedule, as amended by N.L.C.D.265, para. 8. The amendment, which casts a much wider net, includes the race-horse owner, the furniture-maker and the owner of a fishing boat, trawler or vessel other than canoe. Among these would be found quite a number of non-Ghanaians.

13/ See Standard Assessment Instrument 1968 (L.I.590). The curious thing about this piece of legislation is that it excludes a number of persons covered by N.L.C.D.78, sixth schedule, e.g. the building contractor, architect in private practice and engineer in private practice.

14/ N.L.C.D.78, para. 72.

15/ N.L.C.D.78, para. 73.

16/ N.L.C.D.265, para. 4, inserting para. 81A in the principal (Act, N.L.C.D.78).

B. Control through exchange of information

However well a country polices activities within its borders, it cannot expect to achieve maximum results in combating international tax evasion without the assistance of the countries of residence of non-residents affected by its tax laws. It is here that tax treaties including a provision for the exchange of information are vital. Ghana's unfavourable position in this respect could not be more marked. It conducts substantial trade with various European countries, especially the United Kingdom, the Federal Republic of Germany, the Netherlands and Italy, as well as with Japan. It has investments from these European countries and from the United States. Ghana is host to a significant but continually changing foreign population from an even wider spectrum of countries, i.e. those already mentioned and Italy, Denmark, Switzerland, Lebanon, India, Israel, Nigeria and other African countries. Yet Ghana has tax treaties with only seven countries, the majority of which it has no appreciable business dealings with.

Double taxation agreements exist between Ghana and the United Kingdom (1947), Sierra Leone (1950), Nigeria (1950), Gambia (1950), Canada (1952), Sweden (1954), and Denmark (1956). 17/ Of these countries Ghana's financial or commercial dealings with Sweden, Sierra Leone and Gambia are negligible. Denmark has some investment in Ghana, but not much. Ghana's dealings with Canada have mainly been on a Government to Government or public corporation level. So, in effect, only the agreements with the United Kingdom and Nigeria have real meaning. Ghana became independent in 1957. All these agreements were therefore made when Ghana was a colony of the United Kingdom and by the United Kingdom on her behalf. A few agreements concluded since independence have been limited to air transport and shipping. 18/

Double taxation agreements have not, since independence, been popular with the Ghanaian tax authorities. Two factors may have contributed to this. Under the tax agreements in operation, a non-resident who is resident in a country with which Ghana has a treaty, enjoys full exemption from Ghana tax on certain types of income, including profits from operating ships or aircraft, profits or remuneration in respect of services performed in Ghana for a resident of the other country, non-government pensions, royalties other than those paid for the extraction of natural resources, dividends and the remuneration of visiting professors or teachers during the first two years of temporary residence. No doubt there is the reciprocal exemption. But Ghanaian residents undertake no comparable income-producing activities within the jurisdiction of most of their treaty partners. And, in any event, by her tax laws, income derived by Ghana residents from sources abroad is not liable to tax in Ghana unless brought to or received in Ghana. The net result is that the treaties have served merely as a device for reducing Ghana revenue without any compensatory gain whatsoever.

17/ There was one with New Zealand in 1952, but it was abrogated with effect from 30 September 1963.

18/ Air services agreements exist between Ghana and the United Arab Republic (now designated as Egypt), Ghana and Switzerland, and Ghana and Italy. Pan American Airways is exempt from tax under para. 7 of N.L.C.D.78 because of an equivalent exemption in the United States Internal Revenue Code. There is a shipping agreement between Ghana and Italy. Israeli shipping is exempted under para. 7 of N.L.C.D.78.

The typical clause for the exchange of information in these agreements is as follows:

"The taxation authorities of the... and... shall exchange such information (being information available under their respective taxation laws) as is necessary for carrying out the provisions of this Agreement or for the prevention of fraud or the administration of statutory provisions against legal avoidance in relation to the taxes which are the subject of the Agreement. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than those concerned with the assessment and collection of the taxes which are the subject of this Arrangement. No information shall be exchanged which would disclose any trade secret or trade process".

Although not as comprehensive as article 26 of the OECD Draft Double Taxation Convention, it is not very different from it.

Of the forms of international tax evasion known or suspected to be practised in Ghana, information can be sought from the suspected evader's country of residence in a very limited number of cases. It is possible to cheat both source and residence countries by the simple device of keeping two sets of books. Whether this is being done or not by non-residents subject to Ghana's tax laws cannot be ascertained in this state of almost total lack of information from residence countries. It is significant that in spite of the widespread belief that international tax evasion is practised on a large scale, the only request for information made by the Ghanaian authorities of their treaty partners within the past five years has been directed to the Board of Inland Revenue of the United Kingdom to supply particulars of the effective rates of taxation of Ghanaian pensioners resident in the United Kingdom. The object of this being to enable the tax authorities to apply the lower of the rates of tax obtaining in the two countries. It is even more significant that there is no record of any of Ghana's treaty partners requesting information, whether of a routine or specific nature, from it under the exchange of information clause. Information, however, is exchanged between Ghana and many other countries on an informal basis on many aspects of taxation, including policy, legislation and general administration whenever the need arises.

As an attempt to eliminate or at least reduce international tax evasion or avoidance, and considering the fact that it may not be possible to achieve perfect reciprocity in bilateral tax agreements, especially between a developed country on the one hand and a developing country on the other, the tax authorities in Ghana have expressed an interest in a general international type of programme under United Nations auspices which will guarantee the exchange on request of certain types of tax information between member countries. Although reciprocity of concessions and benefits is the primary aim in bilateral agreements, where it is apparent that transactions between the two countries are non-symmetrical, the broad objective of the treaty or arrangement should be met without insisting on a like-for-like exchange rule. For instance, information about income on fixed deposit accounts of the resident of one country could be exchanged for information relating to the cost of goods ordered from the other country by residents of the first country.

Ghana is also interested in entering into reciprocal tax information agreement or arrangements with other countries where such treaties would materially assist in a successful fiscal administration.

The structure of the entire tax system, including the question of tax treaties and other bilateral arrangements relating to taxation, is at present under study by a Tax Review Commission. The Commission has completed hearing evidence. Its recommendations are eagerly awaited.

VI. APPLICATION OF TAX-SPARING PROVISIONS UNDER STATUTES OR TREATIES OF VARIOUS COUNTRIES*

A. Definition of problem

The general nature of the tax-sparing credit and the principal arguments for and against its application are discussed in the Report of the Secretary-General to the Group of Experts prepared for the First Meeting of the Group. 1/

In essence, the tax-sparing credit is an extension of the regular foreign tax credit to taxes that are "spared" by the source country, i.e. that are forgiven or reduced under legislation providing incentives for foreign investment. Depending on the statutory authorization, the tax-sparing credit may be extended to all taxes of the developing country for which the capital-exporting country otherwise grants the regular foreign tax credit (sometimes including taxes paid by subsidiaries in developing countries which distribute dividends to their parents); or it can be restricted to taxes more favourable than the tax treatment on profits earned at home. Otherwise, it is claimed, operations abroad would be favoured over domestic operations with the result that capital, jobs and technology are exported, and the domestic economy and labour force are seriously harmed. 2/

* In the preparation of this chapter, the United Nations Secretariat had the assistance of Henry J. Gumpel, Attorney at Law, Walker, Conston, Schurtman and Gumpel, P.C., New York, who acted as a consultant.

1/ Tax Treaties between Developed and Developing Countries: First Report
(United Nations publication, Sales No. E.69.XVI.2), part II, paras. 24-34.

2/ This argument was recently made with great force in the United States, in particular by the sponsors of the proposed Foreign Trade and Investment Act of 1972 (Burke-Hartke bill). Compare the following statements made by Senator Vance Hartke on 27 February 1972: "The Foreign Trade and Investment Act of 1972... is designed to put our domestic industry on an even footing with foreign competition and make domestic investment just as attractive as investment abroad.... Profits earned by the foreign subsidiary of an American firm are not taxed until they are repatriated. To the extent that the firm does pay taxes to a foreign Government, these taxes count as a dollar-for-dollar credit against any Federal tax liability."

The Burke-Hartke bill and two other bills that are pending before the United States Congress aim at the repeal of the tax benefits for foreign investment that are presently available under United States law, in particular, the foreign tax credit and deferral of United States tax on income of foreign subsidiaries prior to distribution.

Although the techniques applied are similar, the regular foreign tax credit and the tax-sparing credit are quite different. The regular foreign tax credit is a relief measure for the prevention of double taxation. The income to which the credit applies is taxed at the higher of the rate of the investor's home country or the rate of the source country. The tax-sparing credit, on the other hand, extends the relief granted by the source country to the country of the investor's domicile. Depending on the extent of the relief extended by the source country, the tax-sparing credit results in total or partial exemption of the income in both countries.

B. Statutory tax credit

The tax-sparing credit is a unilateral relief measure which does not lend itself to reciprocal treatment by the developing countries; for this reason the capital-exporting countries that extend this benefit are generally concerned to retain close control over its application. Accordingly, the conditions under which the credit is granted are as a rule laid down in a bilateral tax treaty, rather than unilaterally by statute. As an exception, Canada has recently introduced a tax-sparing credit that is incorporated in administrative regulations.

C. The matching credit

The so-called "matching credit" is a credit at a fixed rate or rates which the capital-exporting country grants for certain taxes of a developing country (usually withholding taxes on dividends, interest and occasionally other income from capital). The matching credit may be extended by statute or by treaty. It is not strictly a tax-sparing credit because it applies whether or not the source country waives or reduces its tax. Accordingly, the matching credit is more in the nature of a limited exemption than a device for preserving and reciprocating the tax relief extended by the developing country.

At this time, a limited statutory matching credit is granted by France. The Federal Republic of Germany is in the process of finalizing somewhat similar legislation.

France

France grants a fixed foreign tax credit of 25 per cent for dividends and a 12 per cent credit for bond interest from sources in the French Overseas Territories and the States of the former French Community. ^{3/} Apart from encouraging investment in the developing countries, it is claimed that the matching credit will influence those countries to set their withholding taxes at rates that can be absorbed by the French tax and that it acts as a disincentive to tax competition between these countries.

Federal Republic of Germany

For the first time in German tax history, a statute regulating certain phases of international taxation that has just been promulgated (Aussensteuergesetz)

^{3/} Cameroon, Central African Republic, Chad, Congo (Brazzaville), Dahomey, Gabon, Ivory Coast, Madagascar, Mauritania, Niger, Senegal, Togo and Upper Volta. The legal basis of the credit is an administrative note of 30 March 1968, 1968 Bulletin officiel des contributions directes et du cadastre, 417.

introduces an indirect or deemed-paid foreign tax credit, i.e. a proportionate credit for income taxes paid by foreign subsidiaries of German companies that are actively engaged in business. 4/ The credit is granted in the proportion which the dividends distributed by the subsidiary represent of its total distributable profits. If the subsidiary is domiciled in a developing country, as defined in the applicable statute 5/ and if the parent is entitled to relief under that statute, it will be conclusively presumed that the amount of the creditable foreign income tax is equal to that of the German tax on the dividend. Accordingly, the dividend is exempt from German tax regardless of the amount of the foreign tax. The exemption applies even if the local tax is entirely relieved under applicable incentive legislation. The statutory exemption enlarges the tax-sparing credits for dividends extended under certain tax treaties of the Federal Republic.

D. Unilateral tax-sparing credit

Canada

Prior to the passage of the Tax Reform Act of 1971, the Canadian Department of Finance issued three sets of proposed regulation. One of these regulations covers foreign affiliates of Canadian corporations and includes the rules on tax sparing. 6/

Tax-sparing relief applies to projects that are undertaken in developing countries before the end of 1975 by a foreign affiliate of a Canadian resident corporation. The relief takes the form of an adjustment to the "underlying foreign tax account" of the affiliate, whose size is determined by the amount of income tax that is spared by the developing country. The purpose of the computation is to give the Canadian company the same intercompany dividend deduction, and thus the same amount of taxable dividend income, which it would have if the foreign tax had not been spared.

Example

Canadian corporation C owns all of the shares of F, a foreign affiliate carrying on a manufacturing business in developing country X. X ordinarily imposes a 30 per cent tax on corporate profits and a 15 per cent tax on dividends. F qualifies for a 10-year tax holiday under pioneer industrial legislation of country X. Its earnings for a given year are \$1,000, on which a tax of \$300 has been "spared" by country X.

4/ Article 2(1) of the law amending section 19a of the Corporation Income Tax Law.

5/ Entwicklungshilfe-Steuer-gesetz 1968 of 15 March 1968, BGBl 1968, I, p. 217. The exemption in favour of dividends from subsidiaries in developing countries will apply as long as the statute remains in effect.

6/ "Foreign affiliate regulations", News Release 71-94 of the Canadian Department of Finance of 4 August 1971. The regulations are also reproduced in 3 Commerce Clearing House, Canadian Tax Reporter, pp. 30,009-30,011.

	<u>Tax spared in X</u>	<u>Tax not spared in X</u>
<u>Foreign affiliate:</u>		
Income	\$1,000	\$1,000
Foreign tax thereon	<u> -</u>	<u> 300</u>
Earnings available for distribution	<u>\$1,000</u>	<u>\$ 700</u>
Dividends received by Canadian corporation	<u>\$1,000</u>	<u>\$ 700</u>
<u>Deduct:</u>		
Underlying foreign tax . . .	\$ 510*	\$ 300
2 x foreign withholding tax .	<u> 300</u>	<u> 210</u>
	<u>\$ 810</u>	<u>\$ 510</u>
Taxable dividend	<u>\$ 190</u>	<u>\$ 190</u>

* Twice the amount by which the tax spared by the foreign country (300) exceeds the amount of withholding tax that would be payable to that country if an amount equal to the tax spared were distributed as a dividend to the Canadian corporation (45), i.e. 2 x (300-45), or 510.

To qualify for tax-sparing relief, the foreign affiliate must carry on an active business in a developing country, and the foreign tax imposed on the profits of the business must be reduced under a qualifying tax concession extended by that country.

A tax incentive given by a developing country will be regarded as a qualifying tax concession if

(a) The country has an income of profits tax of general application, or a tax that would be recognized as a business income tax for purposes of the Canadian foreign tax credit provisions;

(b) The concession results in a reduction of the taxes otherwise payable by the foreign affiliate;

(c) The concession does not take the form of an allowance (such as accelerated depreciation) or reserve that would be deductible in computing the profits of the affiliate during the control period;

(d) The concession does not constitute an export subsidy; and

(e) The terms of the concession are clearly defined, and the amount of the tax spared can be readily determined.

As the regulations stand today, tax-sparing relief applies only to taxes on profits from projects which the affiliate undertakes in the developing country, or is committed to undertake, by the end of its 1975 tax year. If the foreign

affiliate later expands its operations, a limitation is applied to the amount of the foreign tax spared in the developing country, with the result that the Canadian tax on dividends from this source is increased.

E. Treaty credits

In the large majority of cases, tax-sparing credits are granted under tax treaties between capital-exporting and developing countries. Some countries, such as the United Kingdom, have special statutory rules outlining the conditions under which a treaty credit may be extended; 7/ in most countries, however, the extension of such relief is part of the general treaty-making power of the Government, subject to the usual ratification procedures. A majority of the treaties which include a tax-sparing clause restrict the application thereof to income from capital - dividends, interest, capital gains or one or several of these categories, perhaps because the source countries traditionally reduce their withholding taxes on these items. Another and smaller group of treaties, notably those concluded by Japan and the United Kingdom, extend the tax-sparing credit to all taxes to which the regular foreign tax credit applies, thus covering taxes on income from direct business operations and those payable by subsidiaries domiciled in developing countries.

In accordance with the mandate given by the Group of Experts at its third meeting in 1971, the discussion which follows is limited to tax treaties between developed and developing countries. It should be noted, however, that there are treaties between developed countries which include a (usually reciprocal) tax-sparing clause (e.g. Italy-Norway (1961) and Greece-Italy (1965)), and occasionally between developing countries, e.g. Malaysia-Singapore (1966) and Ceylon* -Pakistan (1969). None of these treaties, however, includes techniques that are not also found in treaties between developed and developing countries.

Following the presentation of unilateral tax-sparing credits, the following discussion does not cover the comparatively few treaties which include a matching credit. Such treaties have been concluded by France with Algeria (1968, N.R.), Brazil (1971, N.R.), the Comoro Islands (1970, N.R.) and Morocco (1970, N.R.). Treaties of this type have also been concluded between the Netherlands and Spain (1971, N.R.) and between Singapore and Sweden (1968). The matching credit incorporated in those treaties covers withholding taxes on dividends, interest, royalties or any combination thereof and occasionally directors' fees. Some of the treaties named 8/ make the application of the matching credit dependent on the fact that the developing country imposes some tax on the income, thus underlining the similarity between that credit and the usual treaty exemption.

The following analysis covers 55 tax conventions concluded between 11 capital-exporting countries and 24 developing countries, as shown in table 1.

* Now designated as Sri Lanka.

7/ The Finance Act 1961, section 17, allows double taxation relief to United Kingdom residents with respect to certain foreign taxes, even though such taxes are not actually imposed by the foreign country, provided that (a) the foreign tax is relieved in order to promote the development of the foreign country; and (b) the foreign tax relief as such is provided in a double taxation treaty between the United Kingdom and the country concerned.

8/ Algeria-France and Israel-France.

Table 1

Developing country	D e v e l o p e d c o u n t r y											Total
	Austria	Denmark	Finland	France	Federal Republic of Germany	Japan	Netherlands	Norway	Sweden	Switzerland	United Kingdom	
Argentina					X				X			2
Barbados											X	1
Brazil				X		X		X				3
Ceylon*					X	X						2
Greece					X				X			2
India				X	X	X						3
Iran					X							1
Israel	X	X	X	X	X			X	X		X	8
Jamaica											X	1
Korea						X						1
Liberia									X			1
Malaysia						X		X				2
Malta											X	1
Morocco				X								1
Pakistan				X	X	X					X	4
Peru									X			1
Philippines		X							X			2
Portugal			X								X	2
Singapore		X				X	X				X	4
Spain			X	X	X		X	X		X		6
Thailand						X						1
Trinidad and Tobago								X			X	2
Turkey	X							X				2
Zambia						X		X				2
Total	2	3	3	6	8	9	2	7	6	1	8	55

* Now designated as Sri Lanka.

It is evident from the foregoing tabulation that only five capital-exporting countries - France, the Federal Republic of Germany, Japan, Norway, Sweden and the United Kingdom - have treaties including a tax-sparing clause whose number is significant in comparison with the total number of their treaties with developing countries. Among the developing countries outside Europe, only four - Brazil, Israel, Pakistan and Singapore - have treaties of this kind whose number is significant in relation to the total number of the tax treaties of this group with capital-exporting nations. The conclusion is that even within the limited number of existing tax treaties between developed and developing countries, tax sparing is presently not among the relief measures that are frequently applied.

F. Coverage of tax-sparing credits under treaties

Treaties limiting credit to withholding taxes on income from capital

The greater part of the tax treaties which include a tax-sparing clause limit the application thereof to withholding taxes on income from capital and occasionally a few other items, as shown in table 2.

Table 2. Treaties limiting application of tax-sparing credit to income from capital and certain other income

Capital-exporting country	Dividends	Interest	Royalties	Other income
Austria	Israel	Israel	Israel	Israel (capital gains)
Belgium	Portugal	Portugal Spain	Portugal	
Denmark	Israel	Israel	Israel	
Finland	Israel Portugal	Israel Portugal	Portugal	
France	Brazil India Israel French-speaking States of Africa and Madagascar	Brazil India Israel Spain French-speaking States of Africa and Madagascar	Brazil	
Germany (F.R.)	Argentina India Israel Iran	Argentina India Israel Greece Spain	Argentina Iran Ceylon*	

Table 2 (continued)

Capital-exporting country	Dividends	Interest	Royalties	Other income
Japan	Brazil Korea Thailand Sri-Lanka	Brazil Korea Thailand Malaysia Singapore Zambia Pakistan	Brazil Korea Malaysia Singapore Zambia Ceylon*	Other income on which tax is reduced or exempted under special incentive measures designed to promote economic development in the case of Brazil, India, Singapore, Thailand, Malaysia, Zambia and Korea
Norway	 Israel Malaysia Portugal Spain	Brazil Turkey Israel Malaysia Portugal Spain	Brazil Turkey Malaysia Portugal	Turkey (income from independent personal services)
Sweden	Greece Israel	Greece Israel	Greece Peru	
Switzerland		Spain		

* Now designated as Sri Lanka.

The foregoing tabulation shows the wide differences that exist with respect to the scope and conditions of the tax-sparing credit both among treaties of different capital-exporting countries and those concluded by the same country. These variations reflect the different outlook and preferences of the developing countries, as well as the fact that tax sparing is a novel device which has found its way into tax treaties only within the last 10 to 15 years and at this time is still in the experimental stage.

Treaties with wide coverage

A number of tax treaties between developed and developing countries include broadly phrased tax-sparing clauses. Under some of these treaties, the scope of the tax-sparing credit is co-extensive with that of the regular foreign tax credit, i.e. the credit covers all income taxes that would be payable by a resident of a developed country, but for the reduction or elimination of such taxes under the incentive legislation of the developing country. Article II (1) and (3) of the treaty between Brazil and Sweden (1965) reflects this approach:

"(1) Where income from sources within Brazil or capital situated therein under the laws of Brazil and in accordance with this Agreement may be taxed in Brazil, Sweden shall allow the Brazilian tax paid in respect of such income or capital as a credit against any Swedish tax payable in respect of that income or capital...

"(3) In the application of paragraph (1) of this Article, when Brazilian income tax has been relieved or reduced for a limited period of time, the credit against Swedish tax shall be allowed in an amount equal to the Brazilian tax which would have been appropriate to the income concerned if no such relief had been given or no such reduction had been allowed. The provisions of this paragraph shall also apply, for a period not exceeding ten years, when the Brazilian income tax has been relieved or reduced under a programme of economic development."

Substantially similar provisions are included in the treaty between Denmark and the Philippines (1966); the treaties of Sweden with Brazil (1965), Israel (1959) and the Philippines (1966); and the treaties of Japan with Brazil (1967), India (1960), Korea (1970), Malaysia (1970), Singapore (1971), Thailand (1963) and Zambia (1970). The treaties concluded by Japan also include a separate tax-sparing credit for the withholding taxes of the source country on dividends, interest and royalties, or some combination thereof, as reduced under other provisions of the treaty. The conventions of Japan with Malaysia, Singapore, Thailand and Zambia further provide for a deemed-paid tax-sparing credit in proportion to the dividends which a Japanese company receives from a company in the developing country, provided that it owns at least 25 per cent of the latter's stock or capital (in some cases, voting stock).

Extension of the tax-sparing credit to taxes of the developing country that would be absorbed by the regular foreign tax credit, except for the fact that they are waived by the source country, is also the rule under the treaties of the United Kingdom with Barbados (1970), Israel (1963/1971), Jamaica (1965/1969), Malta (1962), Pakistan (1961), Portugal (1969), Singapore (1967) and Trinidad and Tobago (1967/1970). Most of these treaties also provide for a deemed-paid tax-sparing credit for the tax of the corporation in the developing country that distributes a dividend to a United Kingdom company. In accordance with the statutory law of the United Kingdom, as amended in 1971, application of the deemed-paid tax-sparing credit requires that the United Kingdom company own at least 10 per cent of the voting stock of the company in the developing country. 9/

G. Evaluation

A questionnaire entitled "Topics regarding aspects of a credit for tax sparing on which information is desired" was circulated.

At the time of this writing, replies had been received from the Governments of two developed and four developing countries, namely, Ceylon,* Ghana, India, Japan, Turkey and the United Kingdom. Since Ghana has no tax treaties with a tax-sparing clause, only five of the government replies dealt with this topic. The substance of the replies was incorporated in the following survey, in addition to other material.

* Now designated as Sri Lanka.

9/ The treaty with Malta does not provide for a deemed-paid credit for dividends flowing from Malta to the United Kingdom and the treaty with Portugal expressly rules out such a credit. The treaty with Pakistan does not require a 10 per cent or greater shareholding, apparently because this treaty, unlike the conventions with Israel and Jamaica, has not as yet been renegotiated.

Significance of tax-sparing credit to Governments

The members from developing countries attached a considerable significance to the tax-sparing credit, which they felt was needed to preserve the benefits of their incentive laws to investors from developed countries that rely on the foreign tax credit device. The member from one developed country stated that it would agree to include a tax-sparing credit in every treaty with a developing country which makes a request therefor, if necessary after careful examination of the adequacy of the incentive measures offered by that country. One reply from a member of a developing country pointed out that some developed countries have used the tax-sparing credit as a means to exact concessions from the developing countries with which they are in the process of negotiating bilateral tax treaties.

Significance of tax-sparing credit to investors

Most members from both developed and developing countries agreed that it was not possible to give a precise answer to the question whether the tax-sparing credit encourages repatriation of earnings or, conversely, the reinvestment thereof in the developing countries. The replies pointed out that many other factors entered into the investment decision, such as opportunities to expand the business of the investor in the developing country, reinvesting the earnings in some other business in that country, or financing operations elsewhere. Moreover, the financial situation of the enterprise might permit reinvestment or dictate repatriation of profits. One reply from a member from a major developed country stated that the tax-sparing credit was neutral as far as this problem is concerned. Most members from developing countries agreed that the tax-sparing credit made investments more meaningful and attractive and was likely to influence the investor's choice of the situs of operations. Conversely, a member from one of these countries pointed out that the credit would encourage them to look to the developed countries which provided this incentive for their capital needs, because taxes were an important element of the cost of an investment.

While it was obviously difficult if not impossible to trace imports of capital to specific incentives because of their interaction with other factors, a member from one developing country reported that increased imports of capital, plant and machinery which it received from a major capital-exporting country could be shown to be the direct result of the tax-sparing credit incorporated in the tax convention between the two countries.

Notwithstanding the absence of adequate quantitative estimates in this area, it was interesting to note that not one of the replies reported a massive repatriation of profits from the developing countries to the capital-exporting countries as a consequence of applicable tax-sparing credits. While it was recognized that only a limited number of replies had been received to date, it would seem that the fears concerning this point had not been confirmed.

Safeguards

One of the early objections to the tax-sparing credit was that the credit might be abused. It was feared, in particular, that a Government might tamper with the incentive laws of its country or, conversely, institute specious taxes

from which exemptions would then be readily granted. Because of these considerations and the novelty of the device, the older conventions incorporating a tax-sparing credit included a precise description of the incentive legislation of the developing country in effect at the time that the convention was signed, thus tying the credit firmly to that legislation and requiring an amendment of the convention any time it was changed.

Experience with the tax-sparing credit since its inception in the late 1950s had shown these reservations to be unfounded. Accordingly, the more recent conventions were less restrictive and included future incentive laws of the developing country, subject to certain safeguards.

The treaties concluded by Japan extended the operation of the tax-sparing clause to incentive measures of the developing country which modified or added to the existing measures depending on an agreement between the Governments regarding their scope. Most of the treaties concluded by the United Kingdom permitted the application of the tax-sparing credit to exemptions in the developing country that were introduced after the treaty was signed, provided that these exemptions were substantially similar to those which existed on that date, and that they were not modified later or modified only in minor respects so as not to affect their general character. Various treaties included a time limitation of 10 years.

Tax-avoidance or evasion aspects

One of the questions directed to both the developed and the developing countries was whether the tax-sparing credit (or other relief measures) might facilitate tax avoidance or evasion in connexion with investments in developing countries. The question was of particular importance because it had received only scanty attention in the past. No country could be expected to offer or underwrite a relief measure that was a convenient vehicle for depriving it of its revenue.

Most of the replies reporting their experience stated that tax sparing was not likely to encourage tax avoidance or evasion, or that no instances of such practices had come to their attention. One member from a developing country, however, while not asserting that tax incentives were more likely to be abused than other rules of law, pointed to some specific instances of tax avoidance in this area and added valuable general observations concerning this subject.

The reply stated that in one reported case, an existing agreement between a local firm and a foreign enterprise was cancelled and replaced by a practically identical contract so as to bring it within the effective period of a newly enacted incentive measure. In other instances, capital goods exported from a developed country were deliberately overinvoiced, resulting in excessive depreciation charges in the developing country as well as in a loss of foreign exchange that was hidden abroad for the benefit of the buyer of the equipment.

With respect to the possible abuse of treaty relief measures, the reply stated the following:

"Even double taxation relief can provide scope for tax avoidance or evasion, if the facts and figures relating to the claim are not fully and correctly disclosed in the countries concerned. Where tax credit is allowed by a

developed country in respect of tax spared in a developing country on the basis of the investment incentive programmes of the latter, excessive claims for credit cannot be ruled out if the accuracy of the information furnished in regard to the tax spared by the developing country is not properly verifiable.

The larger volume of foreign trade flowing as a result of tax incentives also increases the scope and area of various types of economic offences. But such malpractices in some cases would apparently not justify giving up investment incentive programmes altogether, which have undoubtedly contributed to increased co-operation among the nations of the world in the economic development particularly of the less advanced nations."

The reply recommended increasing the exchange of information between Governments as a remedy for combating the abuses referred to. It further observed that where there was a choice between two methods providing the same incentive, the one which gave the lesser opportunity for tax avoidance or evasion should be selected. For example, the exemption method provided considerably less room for false claims than did the credit method. Finally, the reply recommended that a study be undertaken of various types of investment incentives and other tax concessions extended by both developed and developing countries with a view to determining their vulnerability to tax avoidance or evasion schemes. Such a study would also offer suggestions on how to tighten such measures without sacrificing their economic benefits.

Revenue cost of tax-sparing credit

All replies stated that no information was presently available as to the loss of revenue that might result from the tax-sparing credit; one member from a developing country, however, undertook to make inquiries and submit the results thereof at a later time. The conclusion was that the authorities in both groups of countries remained in the dark as to just how much revenue the developed country was giving up by not strictly applying its world-wide tax jurisdiction.

H. Conclusion

More than any other tax or non-tax incentive, the tax-sparing credit has given rise to extensive debates, especially when its use was first contemplated by major capital-exporting countries. In the view of some developing countries, the tax-sparing credit is the only device that is suitable to prevent frustration of their incentive measures and loss of urgently needed revenue without compensating benefits to the investor. Conversely, representatives of certain capital-exporting countries have severely criticized the tax-sparing credit as violating the standards of tax equity and even depriving these countries of their sovereignty in international tax matters, without compensating benefits to the developing countries. A review of the treaty practice, as it has developed over the years, and of the information that has been received to date from various Governments, suggests that the tax-sparing credit, apart from being applied in a rather limited way, is an incentive measure of only limited usefulness, as are others of this kind.

It has frequently been pointed out that the tax-sparing credit is not actually needed if foreign operations are carried out through a subsidiary organized in the developing country. Except for corporations engaged in the extraction of natural resources and perhaps some others, this is the preferred form for conducting foreign operations. The benefit of local incorporation is, of course, considerably increased if the credit is extended to taxes of the foreign subsidiary, as it is under the British and Japanese conventions summarized above. At present, however, this extension is rather unusual.

After the advent of multinational corporations through which in fact most direct foreign investment is now undertaken, it can hardly be stated as a general proposition that only the tax-sparing credit prevents frustration of the incentive measures offered by the developing countries. The exemptions or rate reductions provided by these countries are not nullified if the investment is held by an affiliate domiciled in a jurisdiction which imposes no income tax or only a minimal tax, or taxes its corporations on a strictly territorial basis or grants a statutory or treaty exemption for foreign dividends and possibly other types of foreign-source income.

The very important question of whether tax sparing results in premature repatriation of profits can probably not be resolved at this time. As noted above, no significant evidence to that effect has yet been brought forward. If the final conclusion should be different, consideration might be given to limiting tax sparing to profits that are reinvested. An incentive for reinvestment could be created by setting the corporate rate at a low level and the withholding tax on dividends at a high level. Other tax or non-tax benefits could be added as called for.

VII. TAX-INCENTIVE PROGRAMMES BY DEVELOPING COUNTRIES TO
ATTRACT FOREIGN CAPITAL AND ALTERNATIVES THERETO IN
VIEW OF OFFSETTING OR ACCOMMODATING TAX PROVISIONS
IN THE CAPITAL-EXPORTING COUNTRIES

A. Basic considerations

The Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries 1/ had an informal exchange of views at its 3rd meeting on the problem of how to avert partial or complete negation of a developing country's efforts to stimulate the inflow of foreign capital through tax holidays or other tax preferences; this negation occurs if the host country's reduction in tax is offset, more or less, with greater or less delay, by an automatic increase in tax due to the Government of the capital-exporting country.

This negation has been avoided by some capital-exporting countries by allowing credit for part or all of the tax "spared" by the host country. The credit is allowed against the income tax otherwise due to the capital-exporting country. The "spared tax" is a tax that the host country has enacted, but from which the foreign-owned company is partly or wholly exempt, usually for a limited period of time. The tax may be either one directly on the profits of the concern, a withholding tax on dividends or other form of investment income payments.

Other capital-exporting countries, however, have thus far not entered into tax treaties containing such a provision. Therefore, the lower the host country's tax, the higher automatically is the tax payable to the Government of the capital-exporting country. The revenue foregone by the host country in an endeavour to stimulate an inflow of foreign capital ends up, not in the hands of the foreign-owned enterprise, but in the treasury of the capital-exporting country's Government.

This problem does not arise with respect to a third group of capital-exporting countries, namely, those that employ the "source principle" for their income taxes. Such countries tax only income the source of which is within their own borders. Income arising from investment abroad or any other activities abroad is not taxed. Accordingly, a reduction in tax granted by a host country accrues fully to the private investor, not at all to the treasury of the capital-exporting country's Government. In practice, there are few important instances of capital-exporting countries that employ the "source principle" comprehensively.

The Ad Hoc Group decided at its 3rd meeting that a study should be made, to be submitted for discussion by the Ad Hoc Group at its 4th meeting in 1972, of alternatives to the credit for spared tax and to tax sparing itself. The aim was to "develop a range of solutions which are regarded as appropriate by the various countries involved". The alternatives to be explored would include "a system of direct investment-assistance allowance outside the capital-exporting country's tax system, but integrated with its tax-treaty programme".

1/ Tax Treaties between Developed and Developing Countries: Third Report
(United Nations publication, Sales No. E.72.XVI.4).

The analysis of each alternative is to cover (a) "the structure and mechanics" of the alternative system; (b) "its compatibility with (i) other governmental policies and (ii) the organization of the various governmental agencies that would become involved in the developed country"; (c) "its probable effects in comparison with 'tax sparing' with regard to such matters as (i) comparison in assistance offered, (ii) the effect of eliminating dependence of investment assistance on the continued maintenance of a tax-incentive programme by the developing country (as is needed in the case of 'tax sparing') and (iii) the effect of offering investment assistance even though no tax-incentive programme is maintained by the developing country (unlike 'tax sparing')"; (d) "administrative" matters; and (e) "other relevant matters". This analysis is carried out in sections E, F, G and H below.

Other "phases of a broad study" would include (a) a description and appraisal of existing tax-sparing provisions; (b) a comparison with the effectiveness of "tax-incentive programmes in the absence of 'tax sparing'"; and (c) an analysis "of the various tax-incentive programmes in developing countries with special reference to the variety of techniques utilized and their particular purposes (e.g. reinvestment or repatriation)", particularly to "focus attention on those /investment-attracting tax incentives/ which possess importance for international tax relationships and negotiations". Again, it is noted that "such a study might also consider a comparison between the use of tax incentives and the use of direct grants by a developing country". These phases of the suggested study are not covered here.

In its "Recommendation for implementation of the objectives for which the Ad Hoc Group of Experts was appointed", the Ad Hoc Group concluded, inter alia, that "the outstanding major subjects include particularly /inter alia/... (c) international aspects of tax incentives and their reciprocation by tax sparing or other methods of investment assistance". The "work programme" detailed at the end of the third report of the Ad Hoc Group included "Tax incentive legislation in developing countries". 2/

Some suggestions are offered in the third report of the Ad Hoc Group of Experts 3/ with respect to the provisions that should be incorporated in a "direct investment assistance allowance" as an alternative to tax sparing.

B. Outline

This chapter is organized as follows. Section C (a) describes briefly the degree to which a credit for spared tax is at present granted under tax treaties between developing countries and major capital-exporting countries; (b) notes the absence of such a credit in certain other capital-exporting countries that use the residence principle; (c) notes the consequences, for the subject of this chapter, of the fact that some capital-exporting countries apply the source principle; (d) touches on the restricted use of the source principle by countries that in general employ the residence principle; and (e) notes that the tax credit discussion will become virtually irrelevant for the Ad Hoc Group as concerns any type of income that they recommend should be taxed only by the source country.

2/ Ibid., paras. 171-176.

3/ Ibid., paras. 177-183.

Section D focuses on case (b) in the preceding paragraph, with particular reference to the United States of America, and distinguishes between the types of business enterprise where a credit for tax sparing, if granted by the United States, would be a significant inducement to investment in the host country, and those where it would be virtually a matter of indifference to the United States investor. Section D also analyses the rationale offered by the United States or inferred to be offered for its decision not to grant a credit for spared tax.

Section E describes three forms of "investment assistance allowance" listed in the third report of the Ad Hoc Group of Experts (paras. 177-183), suggests some implementing details and evaluates each of them as an alternative to a credit for spared tax. The investment assistance allowance would in each case be a cash subsidy from the capital-exporting country's Government to be paid directly to the company operating in the host country. That country is assumed, in section E, not to be engaged in tax sparing. Section F covers the same ground on the assumption that the developing country does engage in tax sparing or makes some other fiscal sacrifice.

Section G describes another alternative to a credit for spared tax, whereby the host country would purchase the newly constructed plant and equipment and newly stocked inventory from the foreign-owned and foreign-financed enterprise and then lease these assets back to that same enterprise at a low rental. The host country would not grant any tax preference to this enterprise, hence, as in the preceding paragraph, no problem would arise with respect to a credit for spared tax. The host country might be presumed to borrow the purchase money from the same business firm or its parent, or through some intergovernmental co-operative financing organization whose capital would come from subscriptions made by the capital-exporting country firms. These subscriptions could be equal to the amounts that each firm had been planning to invest in permanent ownership of the plant, equipment and initial inventory.

Section H describes still another alternative to a credit for spared tax, an alternative, however, that would offer financial aid to countries rather than to particular firms. Any developed country that did not grant a credit for spared tax would agree to turn over to an international financial organization each year an amount equal to the revenue that it collected from its refusal to grant such a credit (for spared tax). The "reverse aid" aspect of the decision not to grant a credit for spared tax would in this way be eliminated. The stimulus to any particular foreign investor would then have to be applied somehow by the developing country itself. It could obtain monies to pay such subsidies by way of grants or loans from the international body.

Section I presents a resumé and comparison, with some conjectures on relative feasibilities and relative effectiveness of these alternatives to a credit for spared tax. No conclusion is attempted as to which of the alternatives is best.

C. Existing use of the credit for spared tax and, alternatively,
of the source principle, in capital-exporting countries

The main capital-exporting countries that allow their domestic corporations to credit a spared tax against the domestic tax are France, the Federal Republic of Germany, Japan and the United Kingdom. Most of these credit allowances are stipulated in bilateral tax treaties. The number of developing countries with which any one of these capital-exporting countries has such a tax treaty is apparently not much more than about half a dozen. The credit for spared tax is usually confined to spared withholding taxes on dividends and sometimes other investment income, instead of applying also to the underlying corporation income tax of the host country. Accordingly, although the principle of credit for spared tax is widely recognized, in practice such a credit still has a rather limited application. 4/

The United States credit for foreign taxes does not extend to spared taxes. Tax treaties with India (1959), Israel (1960) and the United Arab Republic* (1960) were rejected by the United States Senate's Foreign Relations Committee largely if not entirely because they contained a credit for spared tax. 5/

France employs the principle of territoriality, or source principle, by which certain types of income that originate abroad are not subject to French income tax, nor can losses be used to offset French-source income. In general, then, the question of credit for tax spared by the host country does not arise for France with respect to certain foreign income. The large number of tax treaties between France and African and other French-speaking countries may partly be explained by the retention in these countries of much of the French tax system.

France and Switzerland appear to be the major capital-exporting countries that employ the source principle. Some of the Latin American countries that export considerable amounts of capital, gross (for purposes of this discussion a country need not be a net exporter of capital), employ the same or much the same principle, for example, Argentina.

If a country does not broadly apply the source principle, it escapes at least in part the need to decide whether to give credit for a spared tax, in so far as it specifically exempts certain types of foreign-source income, if among those types are the kinds of income that may benefit from a tax-sparing credit. This is

* Now designated as Egypt.

4/ These remarks may understate the extent of crediting for spared tax as it now (June 1972) stands, since they are necessarily based on information published in 1971. See Tax Treaties between Developed and Developing Countries (United Nations publication, Sales No. E.69.XVI.2), p. 1, notes 11-12).

5/ Ibid., note 20.

the case for a country that basically exempts all intercorporate dividends, whether flowing from a domestic or foreign corporation. 6/

As noted in the first paragraph of the preceding section, the question of a credit for spared tax becomes irrelevant with respect to those types of income which should be taxed only by the source country.

D. The case of the United States

The United States federal income tax law allows a credit to a United States corporation, against the United States tax for foreign income taxes paid by it or its subsidiaries, up to the amount of the United States tax and subject to certain limitations, not detailed here. But the United States income tax is not collected until a foreign subsidiary's earnings are remitted to the United States parent as dividends, interest or royalties (again, with exceptions not detailed here). Accordingly, a host country's income-tax preference granted to the foreign subsidiary is not at once fully offset by an increase in United States tax payable unless the subsidiary's earnings are repatriated to the United States at once. If the subsidiary defers repatriation, the United States tax is correspondingly deferred, and meanwhile the host country's tax-incentive measures are helpful to the subsidiary and its parent. If the subsidiary postpones repatriation of any earnings until the host country's tax-preference period ends (if ever), and thereafter repatriates no more than what it earns in subsequent years, the earnings of the tax-incentive years are never taxed by the United States. The host country's tax-relief measures will have been fully effective, even though the United States grants no credit for spared tax. To be sure, eventually, if the foreign subsidiary is liquidated, the earnings of that early period in its life (the tax-incentive period) will then be caught in the United States tax net, at least to some extent. But even in that case, the tax-relief measures of the host country will have been almost fully effective, since tax deferred is tax reduced.

Suppose, for example, that the liquidation and hence the United States tax on the subsidiary's early-years profits occur in the fiftieth year after the first year of profits. Let the rate of interest be 6 per cent. A United States tax of, say, \$100,000 in the fiftieth year would then be no more and no less burdensome to the parent corporation than would have been a United States tax of \$5,429 7/ payable in the first year. At interest rates higher than 6 per cent., the latter figure would be still lower. Even if liquidation takes place in the twenty-fifth year, the tax is the equivalent of only \$23,300 payable in the first year, 8/ reflecting a tax reduction in present-value terms of more than three quarters.

6/ Something like this is the provision found in the Federal Republic of Germany's treaties with developing countries, whereby the German income tax does not apply to dividends received from a foreign corporation actively engaged in business if the German commercial entity recipient owns at least 25 per cent of the distributor's capital.

7/ Compounded annually. See R. S. Burington, Handbook of Mathematical Tables and Formulas (Sandusky, Ohio, Handbook Publishers, Inc., 1958), p. 266.

8/ Idem.

The profits of a branch of a United States corporation, as opposed to the profits of a foreign subsidiary, are taxable by the United States as they accrue, regardless of repatriation. For these cases, which are relatively few but sometimes represent very large corporations, especially in natural resources, the absence of a credit for spared tax always makes the host country's tax-incentive efforts abortive.

The United States refusal to grant a credit for spared tax is said to be grounded on the proposition that this unilateral action by the United States in granting a credit was never intended to be anything but a method of assuring that United States capital invested abroad would not be taxed more heavily than United States capital invested at home, at least as long as the host country's effective tax rate did not exceed that of the United States.

However, many tax incentives in the United States law accorded to income from United States capital employed at home do not apply to income generated by United States capital abroad. Examples are the investment credit and the use of an asset life as much as 20 per cent less than the "guideline" lives promulgated in 1962. On the other hand, deferral of the United States tax until repatriation usually means a tax advantage for United States capital operating abroad. There are still other features of the United States income tax law that can be cited, some on one side, some on the other.

E. The proposed investment assistance allowances

The third report of the Ad Hoc Group of Experts states that tax treaties "may provide for an 'investment assistance allowance' to be made by the residence country to assist investments by its residents in the developing country". 9/ The allowance would be paid "automatically", by an appropriate government "agency" in the residence country, to a company of the residence country that was certified in an eligibility certificate issued by that country's treasury as having "invested in the developing treaty country, either directly or through a subsidiary". The certification would (a) describe the nature of the investment; (b) state the amount of investment made during the year, including (and separately stated) the reinvested earnings of that year; and (c) state the amount of profits received by the company of the residence country from such investment, as dividends or branch profits, in the year in question. Interest or royalties are not mentioned. The relevant section of the third report 10/ does not make the investment assistance allowances dependent on any fiscal sacrifice by the developing country (compare section F below).

This information would be required in order to determine the amount of the allowance, which would evidently also be stated by the treasury in the certification document; the amount might be a proportion of either (a) "any capital investment made by the company in the year" (apparently defined to exclude (b) below); or (b) reinvested earnings in the year; or (c) "dividends or

9/ Tax Treaties between Developed and Developing Countries: Third Report (United Nations publication, Sales No. E.72.XVI.4), para. 179.

10/ Ibid., paras. 177-183.

branch earnings received by the /residence/ company in the year". The three types would not be mutually exclusive, but the proportions would have to be different. 11/

The tax treaty would "specify the types of investments eligible", the "duration of the assistance" and "any other relevant conditions". These "factors" could be "developed" by "reference to aspects and requirements of the investment laws, tax laws and other laws or policies of the developing treaty country". 12/

The treaty would also specify which of the three types of allowance or what combination of them would obtain, and would also stipulate the proportion or proportions that would apply in determining the amount of the allowance.

The same tax treaty could presumably include a credit for tax sparing as an alternative to the investment assistance allowance. The treaty as a whole would still satisfy those who object to the credit for spared tax only on the grounds that it puts pressure on the developing countries to employ tax incentives rather than cash subsidies or other forms of government aid and to confine the tax incentives to the income tax. Inclusion of the credit for spared tax as an alternative to the investment assistance allowance would not please those who view the credit for foreign taxes as a means of ensuring that host countries shall not be allowed to determine the relative total tax bills of United States capital investment at home and United States capital invested abroad (see last paragraph of section D above).

These proposed investment assistance allowances will now be analysed with respect to the points developed in the relevant section of the third report 13/ (see the sixth paragraph of section A above). For the sake of concreteness, the discussion will be in terms of the United States. The first point is "the structure and mechanics" of the allowance. Presumably the tax treaty, once ratified, would obligate the Congress of the United States to enact both an authorizing law and an appropriations law, the latter being for an amount unspecified in money terms, since it would not be possible to foresee the amount needed each year. Instead, the act would have to appropriate whatever amount turned out to be required to meet automatically the demand by eligible United States firms for cash subsidies for certified investments, reinvestments or repatriations. This appropriation would be made to some United States government agency. There might be annual hearings before the relevant sub-committee of the Committee on Appropriations to review the record of these subsidies and to give some idea of the magnitudes likely to obtain in the coming year, but the hearings would not, in contrast to usual appropriations hearings, be aimed at determining a money total to be appropriated.

The discretionary element in granting the subsidy would therefore rest with the treasury. The treasury's eligibility certificate would contain dollar figures, the determination of which would be subject to differences of interpretation of the law and differences in accounting methods. This is evident with respect to

11/ This is inferred from the use of x, y and z per cent for the three types: Ibid., para. 181.

12/ Ibid., para. 181.

13/ Ibid., paras. 177-183.

such terms as "investment", "profits" or "earnings" and "reinvestment", as well as "dividends", "branch profits" or other forms of remittance of income as distinguished from return of capital. The treasury of the developing country, meanwhile, would have no direct say in the matter, though its interpretations of the terms might well be sought as guidelines by the treasury of the capital-exporting country. The developing country would have exercised its discretionary power in the formulation of the tax treaty, as in delimiting the types of investment that would be subsidized. Under the alternative of a credit for spared tax, the treasury of the capital-exporting country would probably have somewhat less discretionary power, but such power would not be negligible, owing to the need to interpret terms such as "spared" or their equivalents, as well as "income tax" and the like.

The second point raised in the quotation in the sixth paragraph of section A above is the "compatibility" in the developed country of the direct investment assistance allowances with (a) "other governmental policies" and (b) "the organization of the various governmental agencies that would become involved". These allowances for foreign investment would be incompatible with the controls to reduce direct investment abroad that the United States has imposed, as well as with the interest equalization tax, were it not for the favoured position allowed under these measures to capital flows to developing countries.

As to the relative effect of the investment allowances, compared with a credit for tax sparing, on the amount of assistance offered (point (c) (i), sixth paragraph, section A above), two powerful forces would be acting in opposite directions. The types of investment to be eligible would be specified in the tax treaty. The developing country would have no interest in narrowing such a list, whereas under tax sparing its own treasury suffers from the tax preferences granted, and the developing country is accordingly cautious in determining these benefits.

On the other hand, the United States representatives in the treaty negotiations would tend to limit the list of eligible types of investment, a posture that they could not well take with respect to a credit for spared tax, which, if granted at all, would be granted no matter what kind of investment the developing country decided should be spared its tax.

In this context, three comparisons of where the fiscal burden lies are relevant. Compared with (a) no tax sparing by the developing country and no investment allowance by the other country, (b) tax sparing with no credit given for spared tax is a burden on the developing country's treasury, a benefit for the other country's treasury and neither benefit nor burden for the private corporation; while (c) tax sparing with credit granted for it is a burden on the developing country's treasury, neither benefit nor burden for the other country's treasury and a benefit for the private corporation; whereas (d) a system of investment allowances as described up to this point is neither a burden nor a benefit for the developing country's treasury, a burden for the developed country's treasury and a benefit for the private corporation. These conclusions would of course be modified if the developing country undertook, by terms of the tax treaty, to match (more or less) out of its own treasury the investment assistance allowances granted by the developed country. This possibility is analysed in section F below.

Introduction of the investment assistance allowances would tend to reduce "the continued maintenance of a tax-incentive programme by the developing country" (point (c) (ii), sixth paragraph, section A above) from what that "maintenance" would be under a credit for spared tax, because of the benefit-burden patterns outlined in the preceding paragraph. The "maintenance" would even be somewhat less than under the present, no-credit-for-spared-tax régime, which does benefit many United States corporations (see above) and is maintained partly for that reason. One complication is the presence of capital from other capital-exporting countries. Unless those countries also entered into the investment-assistance type of treaty, tax sparing would have to be maintained for capital flowing from such countries. Depending on the relative importance of United States capital versus the combined capital from France, Germany, the United Kingdom and the like, an investment-assistance treaty with the United States alone might not lead to much reduction in the developing country's total of tax sparing.

Point (c) (iii), sixth paragraph, section A above has to do with the probable effects of a system of investment-assistance allowance in comparison with the effects of tax sparing in a country where no tax-sparing programme is in effect. In this case, the investment-allowance system might readily become more effective than in the case just covered in the preceding paragraph, since there would be no other capital-exporting countries whose firms were already making use of a credit for tax sparing, and there might even be no tax treaties with this developing country where a credit for spared tax was stipulated. Introduction of an investment assistance allowance for this developing country by, say, the United States might well induce other capital-exporting countries to follow suit. The aggregate result could then be a large amount of indirect development and at no cost to the developing country (see the comparison of burden-benefit alternatives above).

The fourth point in the comparison of a credit for spared tax with the investment assistance allowance is "administrative" matters (sixth paragraph, section A). This topic has already been covered in part in the analysis of where discretionary power, if any, would lie within the governmental frameworks of the two treaty countries (see above). The question remains whether administration would be simpler and/or more effective under cash grants supervised by the developed country than by tax sparing supervised by the developing country, with some validation by the treasury of the developed country when it agrees with the taxpayer's claims for credit for a spared tax.

On this point, the British experiment with cash grants as a substitute for extra depreciation and accelerated depreciation in the period 1966-1971 could be instructive by a comparison of the arguments set forth in the White Paper supporting the grant (1966) 14/ and that supporting a return to the old system of extra and accelerated depreciation (1971). It was hoped, in 1966, that the grants would be more effective by being more selective, since the Board of Trade would pass on each application under general rules. One could infer that this greater selectivity or specificity would require more administrative time and effort than deciding to accept or reject a taxpayer's use of extra or accelerated depreciation, if only because the latter decision could be, and doubtless often was, made by

14/ United Kingdom Parliament, Investment Incentives, Cmd. 2874 (London, H. M. Stationery Office, 1966).

default (in favour of the taxpayer). No such approval by default is possible under a cash grant. On balance, tentatively, it may be concluded that the investment-assistance allowances would be administered more tightly and effectively, but at the cost of more time and effort than tax sparing together with a credit for the spared tax.

The "other relevant matters", the fifth point in the comparison (sixth paragraph, section A above) include (a) the swiftness with which the financed aid will reach the private firm; (b) the certainty, as seen by the firm, that it will in fact obtain the aid, especially for new enterprises that are initially not earning enough profits to make the tax incentive meaningful; and (c) the ability to give particular areas within the developing countries a special stimulus. ^{15/} On these three points at least, the investment assistance allowance would probably make a better showing than tax sparing plus a credit for spared tax, unless (a) a payment were substituted for a carry forward of unused tax incentives in the case of newly established concerns that incurred losses initially, or (b) the very fact that no decisions by default would be possible caused an accumulation of paper work and consequent delays in decisions under an investment-assistance allowance.

F. Combining an investment-assistance allowance system with tax sparing or other sacrifice by the developing country

We have seen that paragraph 181 (a) ^{16/} speaks of "a capital-investment allowance equal to x per cent of any capital investment made by the company /in the developing country in question/ in the year". On the face of it, this provision is quite unconnected with any tax-sparing or tax-incentive device that the developing country may or may not be granting, and so would seem not to be something that could be "integrated with its tax treaty programme".

However, the provision just quoted may be read in connexion with paragraph 178, ^{17/} which states that "the types of investments eligible for such assistance, the duration of the assistance and any other relevant conditions... may be developed, to the extent appropriate, by reference to aspects and requirements of the... tax laws... of the developing treaty country". Possibly, therefore, the "x per cent" allowance could be conditions on the developing country's agreeing to subsidize such investment itself to some stated degree, through an accelerated depreciation, a tax holiday or a cash subsidy equal to a certain part of the investment.

^{15/} There are doubtless other relevant matters that this chapter might cover, including incentives to transfer of labour-intensive technology to densely populated countries or for specific activities, such as agrobusiness, to help remove balance of payments strains resulting from rising food imports to developing countries, and finally joint ventures in the manufacturing industry with local business, with a view to strengthening the local private sector, which may be one of the best guarantees to foreign private investment.

^{16/} Tax Treaties between Developed and Developing Countries: Third Report (United Nations publication, Sales No. E.72.XVI.4), p. 28.

^{17/} Ibid.

Here is the crux of the debate: shall the developed country's aid to the company in question be dependent on or shall it be independent of action by the developing country in the way of tax-incentive devices, cash subsidies, the supplying of free infrastructure or other assistance to that company (or its subsidiary)? To the degree that the former is dependent on the latter, the burden rests on the developing country, not on the developed country (see section F above).

The advantages of having the "investment assistance allowance" quite independent of any assistance given by the developing country are as follows:

(a) It is sometimes difficult to define the giving of assistance, especially a tax subsidy. What about a developing country that grants no tax exemptions or reliefs at all, but, on the other hand, does not impose any corporation income tax? Although no developing country now goes this far in favouring business, the allowance provision contemplated might bring such a tax system into existence. Again, what is "free infrastructure" to the foreign investor? Does this include infrastructure that is also available and free to certain domestically owned concerns? To all firms, foreign-owned or domestically owned? To all households, too?

(b) If the problem in (a) is met by specifying in the tax treaty just what kinds of tax relief or subsidy by the developing country will qualify it as a country where capital from the developed country can get aid from home, the objection can be raised that the capital-exporting country is thereby putting pressure on the developing country to adopt this or that kind of tax-incentive or subsidy. If this objection is met by making the list quite lengthy and varied, there arises the problem of where to stop, before re-encountering the objection in (a) above.

On the other hand, there are certain disadvantages in having the developed country's "investment-assistance allowance" quite independent of the assistance rendered to the foreign-owned corporation by the developing country through tax sparing, cash subsidy, free infrastructure and the like. The disadvantages of such lack of linkage are:

(a) It departs from the principle, held by some, that the amount of aid given, directly or indirectly, by a developed country to a developing country should depend not only on the developing country's relatively great need and its relatively modest ability to finance itself, but also on the degree of effort it is making to do what it can from its own resources. Of two developing countries that are alike in degree of need and in ability to cope with that need, the country that is making the greater effort to help itself, the one that is making the greater sacrifice, should, according to this principle, be given the greater aid whether directly, government-to-government, or indirectly, as through an "investment-assistance allowance" to firms investing in that country (see the last five paragraphs in this section as to just who is making a sacrifice within the developed country).

(b) If the "investment-assistance allowance" is quite independent of whatever assistance the developing country is offering to the foreign investor, the incentive that may be granted by the developing host country to attract foreign capital and technology is thus lessened to that extent, since the aid is

given irrespective of the developing country's sacrifice. To some, such reduction of effectiveness is considered unfortunate. Others will say that there is still nothing to stop the developing country from attracting foreign capital on its own initiative, all at its own expense, not partly at the expense of a developed country, and this is as it should be.

Another possibility noted in paragraph 181 (b) 18/ is "a reinvested-earnings allowance equal to y per cent of any reinvestment of earnings in that year". Again, there is no obvious connexion here with any fiscal or subsidy action on the part of the developing country, but a tax treaty might spell out such a connexion, with the consequent advantages and disadvantages noted above.

This "reinvested-earnings allowance", taken by itself, seems to say that the developed country is not particularly interested in promoting export of capital to the developing country unless that capital is designed to form a base upon which a structure will be built by reinvestment, as opposed to repatriation of earnings. This would seem to be a decision for the developing country to make, and this is the inference to be drawn from this language, especially in view of the third kind of allowance (see below). It is to be inferred that the various alternative types of assistance from the developed country are to be used in connexion with one or another particular type of investment in the developing countries.

We recall that a third possibility is envisaged in paragraph 181 (c): "an earnings-increment allowance equal to z per cent of any dividends or branch earnings received by the company in the year". This kind of allowance exerts, of course, directly the opposite pull from the "reinvested-earnings allowance" discussed earlier in this section; it invites the foreign subsidiary to repatriate its earnings as soon as possible.

Thus the three types of allowance, considered together, permit a mixture of incentives to be constructed, with possibly different weightings. Paragraph 182 19/ stipulates that "The treaty shall specify the requisite percentage /of x, y or z/ and which type of allowance or combination of allowances shall be made in the case of the treaty country. The eligibility certificate /given by the treasury of the developed country to the company resident in that country/ shall in turn state the type of allowance or allowances for which the company is eligible". All in all, this is a very flexible approach.

But none of these devices, at least as formulated in the material just cited, come to grips with the central problem: shall the developed country's financial assistance to the foreign subsidiary (or its parent) be greater, if the developing country itself makes some specified fiscal sacrifice to attract the investment in question, or shall it not be? Shall the developing country be given some opportunity, provided it makes some specified sacrifice of its own, to induce foreign investment with the active support, in part, of the developed country? Or shall it not be given that opportunity? These questions must be faced, and answered unambiguously.

18/ Ibid.

19/ Ibid.

A qualified, but fairly strong "yes" seems to suit best the needs of both the developing and the developed countries, provided that the list of specified sacrifices that will render the developing country eligible to trigger the investment allowance by the developed country is varied enough so that no great pressure is exerted on any developing country to use some particular instrument (tax sparing, for example) in making its fiscal sacrifice. The developed country needs to be assured that the sacrifice it is itself making in permitting some inequity in the fiscal treatment of its investors while giving up tax revenue that it regards rightfully as its own, shall be accompanied by some sacrifice, some fiscal effort, by the developing country as an indicator of the seriousness with which that country views the problem of inducing an inflow of capital from the developed country.

The degree of sacrifice or effort so stipulated can be appropriately modest, to recognize the disparity in fiscal ability to pay of the two countries. For example, the developed country might supply \$2 of cash subsidy to the corporation in question for every \$1 in cash subsidy or tax relief given to that corporation by the developing country. Analogously, for every \$1 of tax spared by the developing country, the developed country might allow \$2 of tax credit - a seemingly favourable extension of proposals made thus far for credit for spared tax, but not excessive from the broader point of view that includes cash subsidies based, not on net income (as is the spared-tax subsidy), but on unit sales, purchase of equipment or perhaps even wages paid.

Admittedly, there remains the problem noted earlier: how is sacrifice or effort to be defined? Can it include altering the tax system to replace corporate-income taxation by an equal-yield increase in personal-income taxation, or in sales taxation? No revenue is lost to the developing country, yet corporate activity, whether by capital from abroad or home capital, will be given a tax-reduction stimulus. But we must recall that in the other cases, too, there will presumably be no actual decline in the developing country's tax revenue: the revenue loss from a tax holiday or accelerated depreciation will be made good by an increase in, say, consumer taxes. There is still sacrifice, but it is by consumers, for the benefit of corporate activity. Complete replacement of the corporate tax by an increase in sales-tax rates is exactly the same kind of sacrifice or effort, carried a little further.

A conclusion as to whether the developing country in question, or rather its non-corporate sector, is making a sacrifice must in principle be reached by comparing what is (e.g. no corporate tax, certain consumer-tax rates) with what would otherwise be (e.g. corporate tax at a certain rate, consumer-tax rates lower). In practice, the only comparison feasible is of what is with what was or with what other countries do. If, then, the developing country in question repeals its corporate tax and raises its consumer-tax rates, it will be deemed to be making, or causing its non-corporate sector to make, a sacrifice. And the tax subsidy being thus given to any one corporation would be simply the product of its profits times the corporate tax rate that, it is presumed, would have existed otherwise. Not that any one expects that the developing country would go this far; no corporate taxes are going to be repealed. The use made here of this extreme, unlikely case is to test the sturdiness of our definition of whether an effort or sacrifice is being made. If our approach gives us a workable test in this extreme case, it should do so in the real-life, less extreme cases, where the corporation-income tax is merely suspended for new firms for some years or is based on profit after accelerated depreciation.

The issue noted in the preceding paragraph is that of "the tax-structure option", where the developing country takes the option of sparing no tax and giving no cash subsidy, but instead imposes its corporate profits tax at a low rate. The accompanying degree of sacrifice by the developing country's non-corporate sectors is achieved through higher sales taxes, personal income taxes and the like. This effort, or sacrifice, might be measured against some standard average-nation rate of corporate-income tax, or simply against the rate of corporate-income tax obtaining in the developed country that is negotiating the tax treaty. There need not be a one-to-one percentage point relation. The developed country might instead undertake to subsidize its resident parent corporation (or that corporation's subsidiary in the developing country) by an amount equal, each year, to some part or all of the difference in the corporation tax rate times the subsidiary's taxable profit for the year.

In comparing the corporate-tax rates for this purpose, allowance must somehow be made for the fact that a high corporate rate may be partly offset by credits at the shareholder level. Accelerated depreciation and other reductions of corporate taxable profit must also be allowed for.

The treatment of shareholders in the developing country could be ignored, in asking this comparison, if the comparison were restricted to an examination of the developing country's treatment of foreign-capital corporations only, or indeed only of such corporations owned by parent organizations that are located in the tax-treaty developed country, for comparison with that developed country's (or an average of other countries') treatment of corporate profits. The treatment given by the developing country to those of its corporations that were domestically owned (or, either domestically owned or owned by foreign corporations not resident in the particular tax-treaty country) could be left out of account in comparing corporate tax rates.

G. Purchase and leaseback: an alternative to tax sparing and to investment-assistance allowances

If neither credit for spared tax nor investment-assistance allowance is acceptable, a third approach is possible, already sketched in section B above: purchase of the newly constructed plant, equipment and initial inventory by the host country Government, followed by leasing these assets back to the foreign-owned company at a reduced rental. This company would be given no tax-sparing or other tax incentives.

The leaseback plan would have what to some would appear an ancillary advantage: the host country Government would never be under any pressure to expropriate the assets, since it would already own them, and the foreign investor would accordingly not have to consider this possibility. To be sure, there is an analogue to expropriation, namely, unilateral cancellation of the lease contract. Such cancellation could be a grave event for the foreign-owned concern, especially if it occurred after the concern had sunk large amounts of its own money in producing and marketing at a loss initially, to open up its markets, and before the expected gains had accrued. Normally, the lease would be for a long term: say, 10 years at a reduced rental (analogous to a 10-year tax holiday), with an option to the firm to renew for another long period at a market rental.

The firm could then make its plans with the same long-range view that it would have if it owned the plant, machinery and initial inventory. There are, of course, cases where the firm would not make plans for so far ahead in any event.

One problem with the leaseback alternative is that it would affect the foreign subsidiary's pre-tax profits (as would indeed, but more clearly so, the investment-assistance allowance). They would tend to be larger than under the case of ordinary private investment in the host country, with no tax sparing, because of the reduced lease charge. They would tend to be smaller, because there would be no capital investment by the subsidiary on which normal interest would have to be earned. This latter element would now be represented by the payments to the parent company by the host country in the form of interest on the money that the host country borrows from the parent company in the developed country. This latter element would now be subject to a withholding tax by the host country (if the interest was at full market rate), but the withholding tax rate would usually be lower than the ordinary profits tax rate in the host country.

The host country would thus be recouping, through the profits tax, part of the incentive benefit it was giving through the reduced lease charge. The lease terms could be set to produce the desired net incentive, computed after tax, assuming that this would not require the host Government to go so far as to put the lease charge at zero and then add a cash subsidy.

The more troublesome aspect is that the capital-exporting country's Government would itself be obtaining part of the benefit through (a) application of its tax rate to the new higher profits (in the year of repatriation and (b) the reduction in tax credit occasioned by the smaller tax collected by withholding. Point (a) could be obviated by provisions in the tax treaty that the developed country would impose its tax rate only upon profits computed as if normal, or market, lease terms were in effect. To protect its revenue, the developed country might also restrict the tax credit to what the tax payable to the host country would be if market lease terms were in effect; but as a means of sharing a small part of the burden with the developing country, the developed country might be willing to forgo this latter stipulation. Point (b) regarding the withholding tax, seems more difficult to deal with. Perhaps as an over or under-offset to its revenue gain under this point, the developed country would be willing to make the concession mentioned in the immediately preceding sentence.

If the full market value of the lease had to be ascertained, this would be a nuisance and a subject of possible dispute, unless some formal rules were agreed to. One such rule could be that under free-market terms the annual lease payments would equal the sum of (a) depreciation; (b) the market rate of interest on the loan obtained by the host country to purchase the property; (c) the maintenance expenses, if any, assumed by the host Government as landlord under the terms of the lease; and (d) property taxes, if any, forgone because of Government ownership as against private ownership. Obtaining agreement on these points might not be easy.

Where does the burden of financing the incentive rest, under this leaseback plan, relative to no tax sparing and no investment allowance? (see section E above). Evidently, it rests on the developing country, since the developed

country's tax revenue is not reduced from what it would be under no tax sparing and no investment allowance. The leaseback plan resembles in this respect a tax-sparing by the developing country with credit granted for spared tax by the developed country (but see section D above). And if care is not taken to prevent it, the leaseback plan would have in it an element of tax sparing with no credit granted for it, that is, an element of reverse aid.

H. Payment into an international financing organization by developed countries to the extent that they profit from developing countries' tax sparing

If none of the alternatives to a credit for spared tax prove acceptable to a particular developed country, which nevertheless understands that its non-crediting of a spared tax creates a form of "reverse aid", it might agree to pay into an international financial fund each year an amount equal to what its treasury is gaining from tax-sparing provisions in developing countries, relative to what its treasury would be getting if there were no such tax sparing. Such payments would leave the developed country no worse and no better off than it would be if the developing countries did not give tax holidays or other forms of tax sparing.

The moneys in this fund would be available for outright grants to the Governments of developing countries, or possibly for long-term loans at zero or low rates of interest. How such a fund would be supervised, what countries would be involved in its decision-making processes and similar questions of structure and operation are not explored in the present paper, except for the allocation problem, to be noted in the next paragraph. An amount presumably significant would be added to the flow of aid each year.

The allocation of the grants or the loans among the developing countries would require a series of steps. The allocation might be based on a tracing process: an estimate would be made, for each developing country, of (a) how much tax revenue it was losing through its tax-sparing provisions for the year in question, and (b) how much of this loss was accruing to the treasuries of developed countries A, B, C and the like. The amount paid into the fund by developed country A would then be earmarked for distribution among developing countries M, N, O and so on, according to these estimates. The making of the estimates would again imply deciding the particular year to which a given revenue loss to the developing country should be attributed, and the year to which the consequent absorption by the treasury of the developed country should be attributed. The two attributions would not commonly be for the same year, given the fact that the developed country does not lose revenue (compared with no tax sparing) until the profits are repatriated - except for branch operations. These remarks apply to the underlying corporation tax or other profits tax; the withholding taxes on dividends do not pose this problem.

The plan in itself would admittedly offer no direct incentive to any particular foreign-owned firm, in contrast with the alternatives discussed in the earlier sections of this paper. No particular firm would help trigger the financial aid to itself on its own initiative, as it could with spared tax plus credit for spared tax, cash subsidy, or nominal or low charge under a lease. But the developing countries would be in a position to grant cash subsidies or

spare taxes or give leases on favourable terms, just because of the additional facilities. Whether the developing country would in fact decide to use this arrangement in this manner cannot be predicted. Perhaps the developed countries would prove unwilling to implement such a plan unless the funds were earmarked for stimulation of foreign investment. Earmarking, however, is not always effective. A developing country might simultaneously cut back on the stimulative outlays it was already financing from its own funds, or (more difficult to ascertain) that it was planning so to finance.

I. Summary

The four methods described in the preceding sections E to H are not only alternatives, but also possible complements to one another, as section F has shown. Developed country A, which now grants a partial or limited credit for tax spared by developing country M might consider that, although it was unwilling to go farther with the credit for spared tax, it might add a cash subsidy. And it quite possibly would have no objection to M's offering the business firm a leaseback plan to supplement the tax sparing with limited credit. As was noted above, the leaseback plan does not cost the developed country any tax revenue compared with the situation of no tax sparing and no investment allowance. Other combinations may be readily imagined. It is therefore not conclusive to simply line up the alternative methods, note the defects and advantages of each, and rank the methods by some sort of averaging of the defects and advantages. To do this is to neglect the possibility of combining one or more of the methods. Nevertheless, as a way of starting to think about the policy options, it may be useful to summarize the chief conclusions reached above with respect to each of the four methods.

The spared tax, with credit for it, is probably the simplest administratively if only because it is the most loosely controlled. The cost rests on the other taxpayers of the developing country. For companies that do not plan to repatriate earnings in the near future, it makes little or no difference whether the capital-exporting country gives a credit for the spared tax. With respect to the repatriating companies, the credit feature may tend to push the developing country into raising its income-tax rate (or to introduce an income tax) and then using the tax-incentive approach, rather than itself giving a cash subsidy or reducing some non-income tax.

The investment-assistance allowance offered without matching action may be administratively more difficult, both because it tends to be more precise and because its structure may be such as not to allow government decision by default. It is a burden only on the developed country (unless some matching action is required), though it may lead to higher returns. It can be more closely tailored to the particular kind of investment action desired and it does not push developing countries into adopting or increasing one kind of tax rather than another.

The leaseback plan might be the most complex of all, at least if a serious effort were made to avoid any reverse-aid element. But since this chapter presents the first analysis that has been made of the leaseback plan, the conclusions reached here must be regarded as highly tentative, subject to

substantial modification after discussion. The burden of the leaseback plan rests on the developing country. It probably does not tend to influence the pattern of the developing country's tax system, though it is certainly no help to the real-estate tax.

Payment by developed countries into an international fund of amounts they are gaining by not granting credits for spared taxes (gaining, relative to a system of no spared taxes) is quite a different sort of plan from the other three. The aggregate burden rests, not on the developed countries, but on the developing countries if the point of reference is what happens under no tax sparing, for in this case the developing countries do spare tax. The benefit does not go to the developed countries either. In a way, there is on the first round no change in burden, the developing countries get back, through the international agency, what they have lost through spared tax. The firm meanwhile has directly gained nothing, but may avail itself of an improved investment climate. All now depends on what the developing country does with the revenue it has recaptured. It may spend it on cash subsidies to the firm or it may reduce non-income taxes, or supply the firm with more free infrastructure than otherwise.

No simple solution emerges. Bilateral tax treaties between developing and developed countries should be easier to agree to, however, if there are several options or combinations of options available.

VIII. TAX SPARING AND ALTERNATE MEASURES IN SRI LANKA*

A. Tax incentives (1951-1964)

A five-year tax holiday for profits and dividends was provided as early as 1951 for the promotion of new industries.

In order to provide an incentive for the development of new industrial undertakings which involve a fairly heavy financial risk, it was decided by the Government in 1951 that a tax holiday should be granted to industrial undertakings which commenced after 1 April 1951, provided the following conditions were satisfied:

(a) It must be an undertaking for the production or manufacture in Ceylon^{**} of goods or commodities which was commenced on or after 1 April 1951;

(b) The undertaking should not have been formed by the splitting up or reconstruction of any business previously in existence;

(c) The undertaking should employ more than 25 persons; and

(d) The undertaking should use electrical energy or any other form of energy which is mechanically transmitted and is not directly generated by human energy.

The period of the tax holiday was originally for three years and was applicable to that part of the profits which did not exceed 5 per cent of the capital employed in the business. The dividends paid during the period of the tax holiday were also exempted in the hands of the shareholders, provided that the dividends were out of "exempted" profits. The tax holiday was extended in 1954 from three to five years.

This tax incentive for new industries did not make an impact on industrial development. There was little response from local investors as well as foreign investors. There were no provisions in the double tax relief agreements which Ceylon concluded during this period for any tax sparing. The lack of new foreign investment may be partly attributed to this. There were very few industries that came up. It was in the context of the difficulties of foreign exchange which arose in 1962/1963 and the consequent restriction of imports, including the total ban on imports of cars and high-priced luxury items, as well as the further liberalization of tax incentives and inducements for the local investor to invest in new industries by the grant of relief from tax for capital invested in approved investments, that substantial increase in industrial development took place. As from the year of assessment 1962/1963, industrial undertakings were given a

* In the preparation of this chapter, the United Nations Secretariat had the assistance of Sangarapillay S. Sittampalam, Taxation Adviser to the Minister of Finance, Ministry of Finance, Secretariat, Colombo, Sri Lanka.

** Now designated as Sri Lanka.

complete tax holiday, i.e. their entire profits, even if the profits exceeded 5 per cent of the capital employed in the business was exempt.

B. Tax incentives since 1964

The tax concessions which have been in force since 1964 are more relevant to the present study and may be summed up as follows:

(A) Industry

(1) Tax holiday for new industries.

The profits of new industrial undertakings are exempt from income tax for a period of five years from the date of production or manufacture. The necessary conditions are:

(a) It must be an undertaking for the production or manufacture in Ceylon of goods or commodities;

(b) The undertaking must not be formed by the splitting up or reconstruction of an existing business;

(c) The undertaking must employ more than 25 persons;

(d) The goods or commodities produced or manufactured by the undertaking must be certified to be of satisfactory quality by an authority 1/ if and when an authority is prescribed for this purpose; and

(e) The prices at which the goods or commodities are sold must be certified to be reasonable by an authority if and when an authority is prescribed for this purpose.

The dividends paid to the shareholders during this period are also exempt from income tax.

Any undertaking which wishes to obtain the tax holiday should apply to the Commissioner of Inland Revenue.

(2) Tax holiday for deep-sea fishing.

The profits of undertakings for deep-sea fishing are exempt from income tax for a period of five years from the commencement of business.

The dividends paid to the shareholders during this period are also exempt from income tax.

(3) Exemption of export-trade profits.

The profits derived from the export trade of industrial undertakings which are approved by the Minister of Finance are exempt from income tax for a period of three years.

1/ The authorities when prescribed will be notified in the Gazette.

The full cost of advertising outside Ceylon incurred solely in connexion with the export trade of these approved industrial undertakings is deductible in full.

(4) Export-trade rebate.

With a view to stimulating industrial exports, a further rebate will be granted to manufacturers with effect from the year of assessment 1965-1966. The rebate will be in the form of a set-off from the tax payable of an amount equal to 5 per cent of the value of the goods exported, provided that the exports resulted in a minimum net earning in foreign exchange of 25 per cent of the f.o.b. value of the commodity.

A schedule of the goods which will qualify for relief will be published in the Gazette.

(5) Exemption of foreign experts and technicians: Section 5 (1)(g).

In order to encourage skilled foreign personnel to come to Ceylon and to assist newly formed industries, provision has been made to exempt the emoluments of foreign scientists, technicians, experts and advisers who are brought to Ceylon and employed by undertakings which are entitled to the five-year tax holiday. The exemption is for a period of three years.

(6) Enhanced development rebate: Section 10 (5).

An enhanced development rebate of 40 per cent is granted in respect of new plant, machinery and fixtures used in the commencement of an approved project.

An enhanced development rebate of 40 per cent is also granted in respect of certain types of buildings used in the approved project.

(New tax structure 1965/1966 - Department of Inland Revenue)

At the same time, in terms of the budget speech 1962/1963, imports were substantially reduced, and imports such as cars and a number of other items were banned altogether. The industrial policy of import substitution was encouraged, and foreign investment attracted by the declaration of a clear-cut policy with regard to repatriation of income and capital, as well as the aforementioned tax concessions.

C. Tax incentives (industries) applicable after 1 April 1969

The tax incentives set out in section B ceased to apply to new industries which commenced on or after 1 April 1969. The tax holiday was thereafter applicable only to undertakings with foreign participation, or which are export-oriented or pioneering industries. The scheme for exemption of export-trade profits was also revised to provide even more substantial tax concessions for export trade in non-traditional exports. Undertakings to which these concessions apply are not yet in production, and some are in the stage of formation. Thus, for the purposes of the present study on tax sparing the tax incentives set out in section B are considered, and not those under the new scheme.

Tax incentives (tourism)

Apart from the new tax incentives for industries referred to in the last paragraph of section B, tax incentives to the hotel industry for the promotion of tourism were provided in 1968 and applied to a hotel undertaking commenced after 1 April 1966.

An investor in hotel undertakings would enjoy the benefit of exemption from tax of dividend income and the undertaking itself obtains a five-year tax holiday. This industry is given an exceptional concession by way of deduction of capital expenditure in determining profits and the concession of paying tax at half the standard rate for a period of 15 years after the expiration of the tax holiday. Seven new hotel undertakings have recently come into operation, and two more luxury hotels are being constructed. The effectiveness of the incentives appears to be very significant.

Investment relief

One of the important tax incentives to promote investment and which is of benefit to a person deriving profits from Ceylon is the tax relief for "approved investments". Capital invested in undertakings for new industries, tourism and a number of approved undertakings is granted tax relief on the following basis:

"Relief from income tax is available to individuals who make approved investments.

Approved investment means an investment in an approved project gazetted under section 16C, 69 or 69A of the Inland Revenue Act.

Approved investment does not include (a) an existing investment (i.e. where an investment is made through the share market); or (b) an investment made after a period of six years from the date of incorporation of the company; or (c) preference shares or debentures.

An individual who makes an approved investment can claim as a deduction from his assessable income for the year of assessment 1969-1970 and subsequent years (a) one half of the approved investment; or (b) one tenth of the assessable income for that year of assessment; or (c) Rs. 25,000, whichever is the least."

(New tax structure 1965/1966 - Department of Inland Revenue)

An individual will have to hold an approved investment for a period of six years, otherwise the relief granted will be withdrawn.

This particular tax incentive has proved very effective, as may be inferred from the amount of the tax rebate, which in 1969/1970 was Rs. 381,439/-, a significant sum. However, it offers no benefit to a foreign investor when making his first investment in Ceylon.

In the special case of tourism (i.e. new hotel undertakings) capital invested in such undertakings by a company is also entitled to tax relief on the following terms:

Investment relief for companies:

"Companies and bodies of persons which purchase shares prior to 1 April 1970 in hotel projects which are gazetted as approved undertakings are entitled to investment relief.

Relief is calculated on: (a) the actual amount of the investment; or (b) an amount representing one fifth of the assessable income; or (c) Rs. 200,000, whichever amount is the least.

The relief to be allowed is so calculated as to secure that the tax payable is reduced to the amount which would be payable if the approved investment is deducted from the statutory income.

The maximum relief available under these provisions is 50 per cent of the approved investment.

The relief will be withdrawn if the investment is realized within six years of the date of investment."

(New tax structure 1969/1970 - Department of Inland Revenue)

Interest

The concessions granted in respect of interest and royalties in Ceylon for the promotion of industry must also be considered, particularly since the incentives for new industries do not provide for any exemption of these incomes.

In the case of a non-resident, income from interest is generally taxed gross (i.e. the total amount of interest receivable without any deduction for expenses), since the institution or credit agency which grants the loan to the investor in Ceylon would not normally be carrying on the business of banking or finance in Ceylon. However, where the foreign institution or credit agency carries on business in Ceylon, the interest is not separately taxed but is included as receipts of the business and included in the determination of the business profits of the institution. The Ceylon law was amended in 1968 to provide for exemption of interest as follows:

"Interest accruing to any foreign credit agency from any loan considered by the Minister of Finance to be essential for the economic progress of Ceylon and granted with his approval by that foreign credit agency to the Agricultural and Industrial Credit Corporation of Ceylon, the Development Finance Corporation of Ceylon, the Ceylon State Mortgage Bank or any commercial bank for the time being operating in Ceylon."

(Section 5(1)(kk) of the Inland Revenue Act)

Royalties

All royalties are taxable, and where the royalty is derived by a foreign investor the income generally taxed is the gross amount of the royalty. In the particular case of royalty income derived from Ceylon by a foreign investor, Ceylon has endeavoured to reduce the tax burden on the foreign recipient by special provisions in a double tax relief agreement.

Rates of Ceylon tax

Since the year of assessment 1965/1966, the rates of tax on companies (resident and non-resident) were as follows:

Resident Companies:

Non-refundable (corporation) tax of 50 per cent;
Withholding tax on dividends 33 1/3 per cent

Non-resident companies:

Non-refundable (corporation) tax of 50 per cent)
Additional tax (in lieu of estate duty) 6 per cent) totalling 56 per cent
This 6 per cent additional tax is treated as income tax for all purposes, including the tax credit to be given by the other country under a double tax relief agreement.

Where the non-resident company makes any remittances, there is a tax of 33 1/3 per cent of its remittance up to the maximum amount of (remittance) of its taxable income.

Where the non-resident company owns immovable property in Ceylon, 5 per cent of the taxable income attributable to the immovable property is charged as wealth tax on the immovable property.

The rates of withholding tax in the case of a non-resident company are as follows: 33 1/3 per cent (on dividends); 67 per cent (on interest, royalties and annuities); and 79 1/9 per cent (on rents).

The rates of tax applicable to non-resident individuals for the years 1965/1966 to 1968/1969 are shown below:

On the first Rs. 15,000 of taxable income, at 20 per cent;
on the next Rs. 5,000 of taxable income, at 25 per cent;
on the next Rs. 5,000 of taxable income, at 35 per cent;
on the next Rs. 5,000 of taxable income, at 40 per cent;
on the next Rs. 10,000 of taxable income, at 45 per cent;
on the next Rs. 10,000 of taxable income, at 65 per cent;
on the balance, at 80 per cent.

(New tax structure 1965/1966 - Department of Inland Revenue)

The rates of tax applicable for the years 1969/1970 are as follows:

On the first Rs. 15,000 of taxable income, at 15 per cent;
on the next Rs. 6,000 of taxable income, at 20 per cent;
on the next Rs. 6,000 of taxable income, at 25 per cent;
on the next Rs. 6,000 of taxable income, at 30 per cent;
on the next Rs. 6,000 of taxable income, at 40 per cent;
on the next Rs. 6,000 of taxable income, at 50 per cent;
on the next Rs. 10,000 of taxable income, at 60 per cent;
on the balance, at 65 per cent.

(New tax structure 1969/1970 - Department of Inland Revenue)

The rate of withholding tax on all income paid or credited to any person out of Ceylon other than a non-resident company is at 33 1/3 per cent. In any particular case, a higher rate may be enforced by a direction of the Commissioner of Inland Revenue.

D. Tax treaties

Ceylon had concluded the following double tax treaties prior to 1964:

- (a) Treaty Series No. 9 of 1950 with the United Kingdom (abrogated in 1965);
- (b) Treaty Series No. 11 of 1957 with India;
- (c) Treaty Series No. 11 of 1957 with Sweden; and
- (d) Treaty Series No. 4 of 1964 with Denmark.

None of these treaties provided for any tax sparing.

The treaties concluded thereafter are:

- (a) Treaty Series No. 3 of 1965 with the Federal Republic of Germany;
- (b) Treaty Series No. 1 of 1966 with Norway;
- (c) Treaty Series No. 4 of 1968 with Japan; and
- (d) Treaty Series No. 4 of 1970 with Pakistan.

The treaty with Norway followed the earlier pattern and did not provide for tax sparing or any other method to make effective tax incentives to promote foreign (Norwegian) investment. The other three treaties have provisions to promote foreign investment.

Tax-sparing provisions are contained in the treaties with Japan and Pakistan. The treaty with the Federal Republic of Germany contains a provision to reduce the tax on royalties. Briefly these provisions are as follows:

Treaty with Japan

Dividend income

Where the incentive laws in Ceylon provide for the total or partial exemption of dividend income derived by a non-resident investor, whether an individual or a company, the amount of Ceylon tax that would have been charged if such dividends were liable to tax is deemed to be tax paid in Ceylon. Japan grants credit in respect of such deemed Ceylon tax against the tax payable in Japan.

Another clause (article VI, para. (5) of the treaty) provides for Ceylon to refund the tax withheld from dividends paid during the five-year period immediately following the expiry of the tax holiday to a Japanese company which holds more than 10 per cent of the share capital of a Ceylon company. Japan would however give credit for Ceylon tax, as in the preceding paragraph, i.e. as if such tax were not refunded to the company.

Royalties

Tax on royalties is reduced to 50 per cent of the tax payable under the laws of each country. In the case of royalties received by a resident of Japan, Japan would give tax credit for the actual Ceylon tax paid, as well as an additional 25 per cent of the Ceylon tax payable under the normal law; i.e. an amount equal to 75 per cent of the Ceylon tax normally payable in Ceylon is given credit in Japan though the amount of Ceylon tax paid is only 50 per cent of the normal tax. The treaty provides that the deemed Ceylon tax is to be calculated at the rates in force at the time of the agreement, and not according to the rates of tax applicable to the particular year of assessment.

Treaty with the Federal Republic of Germany

This treaty was negotiated at the official level in 1958 and finalized at a later date. At that time the inclusion of tax-sparing provisions had not been considered by Ceylon; however, a tax concession in respect of royalties was provided. This concession is on the following basis:

The tax chargeable in Ceylon on royalties paid to a resident of the Federal Republic of Germany is reduced by 50 per cent, i.e. half the normal Ceylon tax to be paid.

This concession was agreed upon on the basis that relief for the tax paid in Germany (even though the person is not a resident in Ceylon) is partly borne by Ceylon so that half the Ceylon tax is given as double tax relief. In return, the Federal Republic of Germany grants tax credit up to 75 per cent of the Ceylon tax even though the amount paid would be 50 per cent of the Ceylon tax.

Treaty with Pakistan

Dividend income

Provision for tax sparing in respect of dividend income is included in this treaty. In terms of this provision, there will be deemed to have been paid by a company resident in Pakistan, in respect of dividends received by that company from a company resident in Ceylon which is entitled to the five-year tax holiday, the amount of the Ceylon income tax that would be payable if the provisions of section 6(3) of the Inland Revenue Act did not apply. In other words, the Pakistan company will be given a tax credit equal to the tax of 33 1/3 per cent on the dividends payable during the period of the tax holiday. (Dividends paid during the period of the tax holiday are exempt from income tax in the hands of the shareholders, and the tax of 33 1/3 per cent is not deducted at the source from these dividends.)

Experts and technicians

The Ceylon law provides tax exemption to foreign experts and technicians (see para. 10(1)E). The treaty provides for tax sparing in that a Pakistan expert or technician will be given tax credit in Pakistan equal to the tax that would have been paid in Ceylon if such income was not exempted, and vice versa.

Royalties

Tax on royalties for the use of any patent, design, secret process or formula, trade mark or similar rights derived from one country by a resident of the other country is restricted to one half. Each country would grant tax credit to its resident for tax paid on such royalties to the extent of 75 per cent of the tax in the other country. This is on the same lines as in the treaties Ceylon concluded with Japan and the Federal Republic of Germany.

E. Implementation of tax sparing and other special provisions

Dividends

The provisions relating to tax sparing and other concessions in respect of dividend income are simple in technique and easy to administer in Ceylon. Where the dividends are exempted from Ceylon tax, no tax is deducted when the dividends are paid by the tax-holiday company. If, however, the exemption does not apply to all the dividends paid by the company, but only to the dividends paid to this particular non-resident, then the tax deducted at source is refunded to that non-resident recipient. This is so in respect of the concession for dividends provided in the treaty with Japan, where such dividends are exempted for a period of five years after the expiry of the tax holiday. The administrative arrangements required for its implementation are simple.

Foreign technicians and experts

The exemption granted to foreign experts and technicians involves no administrative work in the developing country since no assessment is made.

In the working of the tax-sparing provisions and other concessions in respect of dividends, royalties and the employment income of foreign technicians and experts, the home country must presumably obtain a certificate as to the exemption granted (i.e. the non-payment of tax is not due to delay in assessment or oversight in assessment or evasion), as well as to the amount of Ceylon tax deemed to be paid for the purpose of tax credit. Upon presentation of such a certificate, the tax credit due would be granted. In this connexion the Ceylon tax authorities have not received any inquiries, nor have any difficulties been referred to them.

Royalties

The provisions relating to royalties are implemented by the Ceylon tax administration in the following manner:

(a) The Ceylon user would normally pay the royalty in terms of an agreement which is generally scrutinized and approved by the Industries Ministry in Ceylon in order to ensure that the agreement is a transaction at arm's length and does not include any excessive payment;

(b) No assessment would be made in Ceylon. The normal provisions to withhold tax at the source would be applied. A direction from the Commissioner of Inland Revenue so as to deduct the tax at the appropriate rate according to the status of the recipient is given if the normal deduction is less. This would be the correct amount of tax due, and there is no further tax liability on the non-resident recipient;

(c) The person paying the royalty would issue to the non-resident recipient a certificate stating the gross amount of royalty, the tax deducted and the net amount remitted for each remittance during the year. These certificates would be the evidence in the recipient's home country as to the amount of Ceylon tax paid. The Commissioner of Inland Revenue would certify the deduction of tax and, if necessary, clarify further that in terms of the agreement the tax rate is one half as otherwise applicable. This would normally be furnished either at the direct request of the other tax authority or at the request of the taxpayer, who may be called upon to do so by his tax authority in the home country. It is presumed that there have been no difficulties, since the department has had no inquiries or complaints, either from the tax authority in the home country or from the non-resident recipient of the royalty.

F. Technical characteristics

It will be observed that tax-sparing provisions as well as other concessions to reduce the tax burden in respect of income from dividends and employment income of experts and technicians have been framed on the principle of tax exemption in Ceylon and the amount of Ceylon tax that would have been paid being allowed as credit against the tax payable in the home country. The special provision for royalties follows the earlier basis of double tax relief in that the two countries involved relieve in the first instance the total tax burden on that income by reducing it to one half in either country; moreover, the country in which the recipient is resident grants tax credit not only for the actual tax paid in the other (i.e. developing) country, but enhances that credit by a further 25 per cent of the tax in the other country as deemed tax. This is a valuable tax incentive to promote the use of patents and technical know-how. It is visualized that certificates as to the amount of Ceylon tax deemed to have been paid in respect of each of the relevant sources of income may be necessary for use in the home country, but this need does not appear to have arisen so far.

G. Effectiveness in attracting investor

The circumstances in which industrial development really progressed after 1963 are briefly set out in section C. The double tax relief treaties came into force with effect from the year of assessment 1958/1959, in the case of the Federal Republic of Germany, and 1968/1969, in the case of Japan.

By the end of 1966, there were twenty-two new industries with foreign participation. These, however, included certain industries previously carried on as a branch undertaking by international industrial combines, which were later converted into subsidiary companies registered in Ceylon. Of the twenty-two new industries with a foreign capital investment of a little over Rs. 75 million, the subsidiary companies referred to above account for Rs. 67 million. Of these subsidiaries, one particular industry which has been operating in Ceylon for a number of years previously accounts for Rs. 56 million.

Volume of investment

In order to determine the effectiveness of the tax-sparing provisions, it is necessary to analyse the total investments in new industries made in this period by other countries as against those by Japan and the Federal Republic of Germany.

The following tables, prepared from information available in the Ministry of Industries in Ceylon, describe the situation:

Table 1

	<u>No.</u>	<u>Total capital</u> (Rs.)	<u>Foreign capital</u> (Rs.)
Group <u>A</u> . . .	3	62,000,000	59,700,000
Group <u>B</u> . . .	3	8,679,000	7,327,000
Group <u>C</u> . . .	16	40,180,831	10,505,009
Total	22	110,859,831	77,532,009

(Group A: Subsidiary companies registered to take over existing undertakings; Group B: Undertakings previously carried on by non-residents and which have now been transferred to new companies registered in Ceylon with Ceylonese participation; Group C: New industrial undertakings with foreign participation.)

The undertakings in Group C are analysed as between Japan, Germany, Pakistan and other countries in table 2 below:

Table 2

	<u>No.</u>	<u>Total capital</u> (Rs.)	<u>Foreign capital</u> (Rs.)	<u>Total profits</u> (Rs.)	<u>Total dividends remitted</u> (Rs.)
Japan	7	22,011,171	5,580,009	22,270,127	4,352,020
Germany	1	12,000,000	2,000,000	Not available	
Pakistan	Nil	Nil	Nil	Nil	Nil
Other countries	8	6,169,660	2,925,000	15,957,604	2,305,792
Total	16	40,180,831	10,505,009	38,227,731	6,657,812

(The profits and dividends correspond to the years 1965/1966, 1966/1967, 1967/1968 and 1968/1969.)

The actual figures of industrial growth are shown in table 3 below:

Table 3

	<u>1960</u>	<u>1963</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>
Industrial production at constant prices (Rs.Mn)	728	853	1008	1052	1154	1221	1335	1379
Growth rate over previous year		7.1	7.6	4.4	9.7	5.8	9.3	3.3
Industrial exports at: Constant prices . . . (Rs.Mn)	73	73	70	80	88	89	122	128
As percentage of domestic exports at constant prices . .	4.1	3.8	3.7	4.0	4.3	4.5	5.9	6.3
As percentage of industrial production at constant prices . .	10.0	8.6	6.9	7.6	7.6	7.3	9.1	9.3

Source: Central Bank of Ceylon, Annual Report 1971, p. 15.

The volume of industrial activity is reflected in the above statistics. It will be seen that the industrial production at constant prices, which was Rs.728 million in 1960, had increased to an annual average of about Rs.1,350 million for the years 1970 and 1971, representing an 86 per cent increase over this period.

This increase in production is due to the expansion of industrial undertakings which existed in 1960, as well as to the additional production from the new industries referred to above. The increased production from the old industrial undertakings can also be attributed to the fact that new patents and know-how were utilized during this period. However, the increased productivity is mainly due to the new industries analysed in table 2 above.

Inferences

It will be observed that there has been no investment from Pakistan probably because of unsettled conditions.

The treaty with Germany, which only provides for concessions in respect of royalties, appears to have resulted in one substantial investment in the textile industry.

On the other hand, the Japanese have invested in a variety of industries, predominantly textiles, but also production of radios, batteries, metal sheets and rubber sheets.

It will be seen from the statistics in table 2 that industrial development in which there was Japanese participation accounts for nearly 55 per cent of the total in terms of capital investment as regards the amount of foreign capital and the capital investment total (both foreign and local). In the case of the Federal Republic of Germany, there is only one industrial concern, which, however, accounts for nearly 30 per cent of the total capital of all new industries and just below 20 per cent if only foreign capital invested is taken into account.

It is clear that the impact of the treaty provisions with Japan has been considerable, and that Japanese capital well above the normal level has been attracted into investment in Ceylon. The high percentage of new investment by Japan, in a country where investment from the United Kingdom had previously been the most significant and Japanese investment negligible, can be largely attributed to the tax-sparing provisions and concessions granted. There is no doubt that the repayment of the tax deducted from dividends paid to a Japanese shareholder for a period of five years following the tax-holiday period, coupled with a corresponding tax-sparing provision, has proved very attractive.

Though the convention with Japan came into force only with effect from the year of assessment 1968/1969, investment by Japan had already commenced owing to the following circumstances:

The treaty with Japan was concluded at the official level in January 1964. Owing to the change of Government in 1965 and other factors, the treaty was approved by the Government in 1966 and signed on 12 December 1967. This convention came into force in the year of assessment commencing on 1 April, the calendar year in which it was ratified, unlike other conventions where the year of assessment was determined when the agreement was initialled at the official level. As this convention was ratified in 1968, the first year of assessment to which it applied was 1968/1969. The year of assessment 1968/1969 makes it applicable to the profits of the calendar year 1967, so that the concessions applied to dividends declared in 1967 (including those declared out of the 1966 profits). Since 1964 Japanese investors had shown considerable interest in investing in Ceylon, so that new industries promoted by them had begun to operate by 1966.

In the case of the Federal Republic of Germany, only one new industry was set up with their collaboration; however, there is substantial activity, particularly in the construction industry, in which technicians and experts as well as equipment have been made available from the Federal Republic of Germany.

Royalties

The case of royalties must be viewed differently. The use of patents and processes is as productive when utilized in modernizing and expanding old industries as in new industries. The particulars of royalty payments in recent years indicate that more royalties had been paid in common with existing industries than with new ones. Residents in the United Kingdom and United States are in receipt of most of these royalties. It is also significant that none of these royalties apply to the industries in table 2; they appear to be mostly for existing industries. Taking into account royalties payable under agreements already concluded, but where payments had not yet been made since production had not begun by the end of 1970, the information available is set out briefly below:

Payments to residents in the United Kingdom . . .	7
Payments to residents in the United States	3
Payments to residents in Japan	1
Payments to residents in the Federal Republic of Germany	1
Payments to residents in Malaysia	<u>1</u>
Total . . .	13

The royalty payable is a fixed annual sum in four cases, per unit of production in four cases and a percentage of the sales in six cases. Of these fourteen cases, five consist of new undertakings carried on by new companies established for that purpose, and the others are to provide additional means of production for existing companies.

Income from royalties is taxed gross without any deduction for expenses. It will be seen from the rates of tax set out in section I, that the Ceylon tax is very heavy and is not likely to promote the substitution of improved patents and processes in place of earlier ones, which though out of date may suffice for production of goods for the home market unless the tax burden is reduced by means of double tax relief agreements. The non-resident recipient has in nearly all cases assured himself of receiving reasonable income by stipulating in the agreement with the Ceylon user that the payment of royalty should be net of Ceylon tax. This will result in a severe burden to the user of the royalty and would increase the cost of goods manufactured.

Tourism

It may be relevant to note the circumstances of foreign investment in the tourist industry in Ceylon. The incentives for tourism are set out in section E. These tax concessions are substantially higher than those provided for other industries under Ceylon tax laws and compare very favourably with the corresponding incentives provided by any other country. The first luxury hotel (five-star hotel), was opened with the collaboration of BOAC (United Kingdom), and two other first-class hotels, one of which is in collaboration with the Hilton group, will open shortly; the other, in collaboration with the Intercontinental group, is under construction. These investments in new hotels from foreign sources do not have the benefit of any concessions under a double tax relief agreement. Ceylon has no double tax relief convention with the home country of these investors. Another reason for the significant investment in the tourist industry may be the attention the Government has given to the setting up of a separate ministry for tourism and the work done by the corporation set up specifically for this purpose, namely, the Ceylon Hotels Corporation, which actively promotes the tourist industry in every way.

H. Financial loss

It is difficult to ascertain the financial loss, if any, arising from tax incentives consequent to the tax exemptions and the tax-sparing provisions, particularly in the case of a developing country. The setting up of new industries results in employment, creation of income and, in today's special circumstances, very valuable foreign exchange, which would otherwise not have been available to

the developing country. These advantages outweigh the direct loss in revenue due to the exemption from tax of the new income that is created. The direct loss of revenue in one case of industries set up with Japanese collaboration at the rate of 50 per cent company tax and 33 1/3 per cent tax on dividends for three years paid would be as follows:

Net profit	Rs.22,270,127
Ceylon tax at 50 per cent	Rs.11,135,063
Total dividends (approx.) . . .	Rs.16,500,000
Tax at 33 1/3 per cent . . .	Rs. 5,500,000
Dividends remitted	Rs. 4,352,020
Additional 6 per cent tax	Rs. 259,120

(Total loss of revenue, approx. Rs.18 million.)

There is, however, some gain in revenue consequent on the imposition of a turnover tax on the manufactured articles. Turnover-tax revenue is said to have exceeded in these cases the actual direct tax revenue that had been lost. There is, however, a distinct loss to the developed country from which capital and technical collaboration is made available to the developing country. In the particular case referred to above the loss of revenue to the home country, say Japan, would be the loss of tax in respect of the dividend income remitted to that country. This loss of tax revenue would not exceed the amount of tax credit to be allowed under the agreement. This tax credit is equal to the amount of Ceylon tax relieved by the exemption granted to the dividend income arising in Ceylon. The amount of that tax is 33 1/3 per cent of the dividend remitted, i.e. Rs.1,450,640, and 6 per cent additional tax, i.e. Rs.259,120, totalling Rs.1,709,760. The loss may, however, be less, since the credit is subject to the provisions of the Japanese law regarding the allowance as tax credit against Japanese tax of the tax deemed payable in Ceylon. On the other hand, the above-cited example shows that very nearly the entire capital invested has been repatriated in a short time by way of dividend income and that the creation of this source of foreign income is itself a gain to the developed country as well.

I. Effect on reinvestment or repatriation of profits

It has been generally argued that unless there is a dividend limitation, tax exemption of profits and dividends will result in greater distribution of profits, which reduces fresh capital formation and the expansion of industry. Profits are likely to be reinvested only when there is no advantage to be gained by a liberal distribution of profits in excess of what would otherwise be a reasonable distribution. In the particular case of Ceylon, where the tax structure provides for the deduction of lump-sum depreciation and development rebates, the tax exemption granted in these cases in effect nullifies the benefit of these provisions. It would induce the new industry to defer any further expansion until after the tax-holiday period is over, when expenditure on further development would qualify for deductions. On balance, the gain in foreign exchange and the need to compete with other developing countries which grant tax concessions have induced Ceylon to provide for such concessions and ensure the retention of the benefit to the non-resident investor through tax-sparing provisions.

The volume of investment that was made in Ceylon during the period under examination up to 1967 is a good measure of the effectiveness of the incentives provided, including tax-sparing provisions; it is impressive in the context of the changing conditions in this country and the changes in government policy, particularly with regard to the private sector and the coverage by the public sector. Other than the investment in those sectors for which special concessions have been made, namely, tourism and industry, there has been negligible investment in other sectors. The extent of Japanese and other foreign investment actually made in the sectors of industry and tourism is therefore very significant. The Japanese investment is only in consequence of the special provisions that became available to them in terms of the double tax relief agreement. The comparative volume of investment is very considerable, taken in the context of the total industrial investment. In the other sector in the country in which substantial new investment was made, i.e. tourism, new investment is the only significant investment.

J. Observations

The administration of the scheme of tax sparing in the treaties referred to has so far proved simple and effective. Another method that may be adopted to achieve the same objective, namely that of investment grant, must be administered by the home country, and no views on that are expressed here.

The tax-sparing provision adopted by Ceylon has been easy to administer and ought not to give rise to any tax-evasion or avoidance practice in the home country. The tax administration in Ceylon has not come across any problems of avoidance or evasion. Experience in Ceylon shows that, in the case of the developing country, a simple scheme of tax concession which exempts income in the developing country and has a corresponding tax-sparing provision in the convention with the other country is easy to administer and is effective in achieving its objective of attracting investment.

ANNEXES

ANNEX I

QUESTIONNAIRE ON EXCHANGE OF INFORMATION

Exchange of information: routine transmittal

One form of exchange of information between income and death gift tax administrations is that of one tax administration routinely supplying information without any specific request in a particular case. Several aspects of routine transmittal can be explored.

From the standpoint of the administration receiving the information:

1. What kinds of information are desired to be routinely received?
 - (a) Types of income or property shown on returns: dividend payments, interest payments, real estate, shares, and the like;
 - (b) Amounts of tax due or paid;
 - (c) Nature of information: amounts, name, address of recipient, and so on;
 - (d) Recipient's name, address(es), and so on;
 - (e) Payor's name, address(es), and so on;
2. What use, routinely or by specific selection, can feasibly be made of the information received? What types of evasion are most likely to be detected or prevented?
3. What agencies in the requesting country are likely to have access to the information received?
4. Any other relevant factors.

From the standpoint of the administration transmitting the information:

1. What kinds of information can feasibly be routinely transmitted?
 - (a) Limitations of law or practice;
 - (b) Differences in kind of information requested;
 - (c) Effect on competitive position of taxpayers involved as a result of differing practices regarding the disclosure of information by requesting countries and responses to requests by other countries;
2. Advantages and disadvantages to the transmitting administration;
3. Any other relevant aspects.

Exchange of information: specific requests

Another form of exchange of information between tax administrations is that of one tax administration making a specific request for information regarding a particular taxpayer or situation. Several questions can be explored in the consideration of the scope of such specific request procedure.

From the standpoint of the administration making the request:

1. Assuming that there is no routine transmittal of information:
 - (a) In what kinds of cases is information likely to be requested, what is the purpose of seeking the information and what types of information are generally involved?
 - (b) What agencies in the requesting country are likely to have access to the information?
 - (c) Any other relevant aspects, including the form and average frequency of such requests in any given year;
2. Assuming that routine transmittal is already in operation:
 - (a) In what kinds of cases is information likely to be requested, what is the purpose of seeking the information and what types of information are generally involved?
 - (b) Forms of such requests, channels of communication, delay in answering.

From the standpoint of the administration receiving the request:

1. What are the considerations that shape the nature of the response to a specific request for information;
2. What advantages may the transmitting administration expect to gain from its co-operation?

Exchange of information: discretionary transmittal

A third suggested aspect of exchange of information is that of transmittal by a tax administration of information discovered by it in an audit or other investigation, which information could reasonably be considered to be of importance to the tax administration of a treaty partner.

1. What are the factors involved in considering whether it is feasible and desirable either:
 - (a) To place an obligation in a treaty on tax administration to follow such a procedure; or
 - (b) To consider it appropriate that treaty countries endeavour to try to follow such a practice as a voluntary matter;
2. To what extent would such transmittal prove less - or more - burdensome than routine transmittal;
3. In case of transmissions of such information under the provisions of a treaty, what safeguards should be provided for to protect the interests of the transmitting country or to avoid undue hardships to individual taxpayers.

ANNEX II

QUESTIONNAIRE ON ASPECTS OF A CREDIT FOR TAX SPARING

Topics addressed to experts in developing countries

1. Statement of provisions in tax treaties with developed countries that commit the developed country to giving a credit for tax spared by the developing country:
 - (a) Exact wording of the clauses;
 - (b) Commentary on the effective meaning of these clauses;
2. Instances where the developing country has attempted to obtain such a provision, but where the developed country has not agreed to offer such a credit (with comments, if possible, on the apparent reasons for failure to obtain such a clause);
3. Detailed description of the type of tax-sparing legislation or decree in the host country that leads to tax credit in the capital-exporting country, under the tax treaty, for spared tax;
4. Description of types of income-tax incentives that the developing country has employed that have not qualified for the tax-sparing credits referred to in No. 1 above;
5. Can you provide some specific examples of capital imports influenced by the credit for spared tax or other investment incentive measure given by the capital-exporting country?
6. Brief description of tax incentives other than income-tax incentives offered by the developing country to foreign investors;
7. Estimate of the revenue forgone by the developing country with respect to income that qualifies for the tax-sparing credits provided by developed countries;
8. Tax-evasion or tax-avoidance aspects, if any, of investment assistance and double taxation relief, including tax sparing;
9. Other administrative problems, if any, that have arisen under investment assistance and double taxation relief, including tax sparing;
10. Other remarks, if any, arising from the developing country's experience with tax incentives in the developing country (a) with, (b) without a credit for spared tax being given by the investor's home country.

Topics addressed to experts in developed countries

1. Clauses in existing treaties with developing countries that give a credit for spared tax or that offer somewhat similar methods of allowing tax incentives given by developing countries to be effective.

- (a) Exact wording of the clauses;
 - (b) Commentary on the effective meaning of these clauses;
2. Brief description of negotiations leading up to agreement on these clauses in each case;
 3. Provisions in other parts of the treaty or in the developed countries' income-tax law that make the credit for tax sparing either superfluous or of limited practical importance (for example, a provision exempting in any case all intercorporate dividends coming from abroad);
 4. Rough estimate of the amount of revenue forgone by the developed country as a result of the credit for spared tax;
 5. Possible additional stimulus, if any, to be gained by extending the credit for spared tax to the underlying corporate income tax of the developing country in those cases where the present credit for spared tax applies only to the developing countries' withholding taxes on dividends, interest and royalties that are spared;
 6. Distinction, if any, between credits for withholding tax spared on dividends, interest and royalties, if any such distinction exists and is significant;
 7. Some conjecture or estimate of the effect of the credit for spared tax on decisions by the taxpayer to repatriate earnings more promptly than otherwise or, on the contrary, to retain more of its earnings in the developing country than otherwise;
 8. Tax evasion or tax avoidance, if any, arising from investment assistance or double taxation relief, including tax sparing;
 9. Any other observable or conjectured effects of the credit for spared tax on financial and investment decisions by the taxpayer.

ANNEX III

SUMMARY OF RESPONSES TO THE QUESTIONNAIRE ON ASPECTS OF A CREDIT FOR TAX SPARING

Topics addressed to experts in developed countries

Members from the following countries responded to the questionnaire on aspects of a credit for tax sparing, and their answers are used in this summary: Japan, Norway and the United Kingdom.

1. Clauses in existing treaties with developing countries that give a credit for spared tax or that offer somewhat similar methods of allowing tax incentives given by developing countries to be effective:

- (a) Exact wording of the clauses;
- (b) Commentary on the effective meaning of these clauses.

A number of agreements concluded by developed countries provide credit for taxes spared by the developing countries under their tax-incentive laws to promote their economic development. The replies from experts from developed countries point out that most of the developing countries had adopted specific incentive measures of tax reduction or exemption to induce foreign investment that might help in promoting their economic development. In order to assist the developing countries in attaining these objectives, some developed countries extend credit for taxes spared in double-taxation treaties with developing countries. Some treaties provide that for the purposes of tax credit the amount of tax shall be deemed to have been paid which would have been paid if the foreign tax would not have been reduced in accordance with their tax-incentive legislation. The purpose is to avoid that reduction in tax by the developing countries to attract foreign investment should serve to increase the home country's tax instead of benefiting the investors. In the same treaties there are provisions for including credits with respect to maximum rates of withholding tax on dividends and interest. The conventions usually enumerate the provisions of domestic laws providing incentives for which a tax-sparing credit is to be granted. Some developed countries grant tax-sparing credit to incentives under special measures effective on the date of signatures of the convention, as well as to those which may be introduced in future. A number of tax-sparing clauses limit the application of these measures to dividends and/or interest and/or royalties.

2. Brief description of negotiations leading up to agreement on these clauses in each case.

The responding experts stated that when a developing country requests a tax-sparing credit in the negotiations for a double-taxation agreement, this credit will be granted as part of a fair and balanced agreement, usually after careful

examination of the adequacy of the incentive measure offered by the requesting country.

3. Provisions in other parts of the treaty or in the developed countries' income-tax law that make the credit for tax sparing either superfluous or of limited practical importance (for example, a provision exempting in any case all intercorporate dividends coming from abroad).

Some responding experts declared that there are no provisions in their tax law or double-taxation agreements which make the credit for tax spared either superfluous or of limited practical importance. Some capital-exporting countries limit the scope of the credit for tax sparing.

4. Rough estimate of the amount of revenue forgone by the developing country as a result of the credit for spared tax.

No figures were supplied for a tax forgone by the developed countries as a result of credit given for tax sparing under a double-taxation agreement.

5. Possible additional stimulus, if any, to be gained by extending the credit for spared tax to the underlying corporate income tax of the developing country in those cases where the present credit for spared tax applies only to the developing countries' withholding taxes on dividends, interest and royalties that are spared.

Some responding experts stated that there is an indirect credit system under their domestic tax laws and that the credit for tax spared may be granted in respect of foreign tax on profits out of which dividends are paid by the subsidiary corporation to its parent corporation. Some treaties provide that if the parent company owns at least 10 per cent of the shares of a company resident in the developing country, the credit shall take into account, in addition to the tax on dividends, the developing country's tax payable by the distributing company on the profits from which such dividends are paid. In this case, credit for tax spared, including underlying tax, can only be given where credit would have been due if the tax had actually been paid.

6. Distinction, if any, between credits for withholding tax spared on dividends, interest and royalties, if any such distinction exists and is significant.

Responding experts noted that there is no distinction between credits for withholding tax spared on dividends, interest and royalties.

7. Some conjecture or estimate of the effect of the credit for spared tax on decisions by the taxpayer to repatriate earnings more promptly than otherwise, or, on the contrary, to retain more of its earnings in the developing country than otherwise.

Most members from developed countries agreed that it is impossible to give a precise answer to the question whether the tax-sparing credit encourages repatriation of earnings or, conversely, repatriation from the developing countries. The replies stated that a credit for tax spared will undoubtedly be taken into account in the taxpayer's decision to repatriate earnings more rapidly. However, the taxpayer's investment decision will depend also on a number of other factors, which may vary according to the circumstances of the individual case (such as

opportunities for expanding the enterprise in the developing country, reinvesting the earnings in some other projects there, general financial position of the enterprise, its activities or projected activities in other countries and so on). One reply stated that the effect of the credit for spared tax is neutral as regards the decision of the taxpayer to repatriate or retain his earnings. Under this capital-exporting country is tax legislation, a taxpayer who is resident in a developed country is taxed on his income derived from sources both within and outside the developed country, regardless of whether or not that income is remitted to the country of residence.

8. Tax evasion or tax avoidance, if any, arising from investment assistance or double-taxation relief, including tax sparing.

One reply reported that tax sparing is not likely to encourage tax avoidance or evasion. Another reply from a developed country stated that its double-taxation agreements with developing countries provide that certain specified relief given by the developing country tax laws are to qualify for tax-sparing credit, so long as they are substantially modified after the date of signatures of the agreement. Normally, there are also provisions for future relief to qualify for tax-sparing credit if the two countries agree that the provisions are of substantially similar character in the agreement. This method minimizes the risk leading to tax avoidance or evasion.

9. Any other observable or conjectured effects of the credit for spared tax on financial and investment decisions by the taxpayer.

The responding members pointed out that credit for tax spared will make a particular project more attractive to the taxpayer, but there are many other important factors which will affect the taxpayer's financial and investment decisions. Therefore, it appears difficult to isolate the effect of the credit for spared tax on the taxpayer's investment decisions. However, there is no doubt that the existence of a tax-sparing credit affects the taxpayer in the selection of the foreign country in which he will invest. The tax-sparing provisions may encourage developing countries to enact tax-incentive laws and thereby attract capital from investors in industrialized countries.

Topics addressed to experts in developing countries

The replies from members from Argentina, Ceylon,* Ghana, India, the Philippines and Turkey are summarized below:

1. Statement of provisions in tax treaties with developed countries that commit the developed country to giving a credit for tax spared by the developing country:

(a) Exact wording of the clauses;

(b) Commentary on the effective meaning of these clauses.

* Now designated as Sri Lanka.

Members from these developing countries, which have tax treaties with developed countries, expressed interest in the inclusion of a tax-sparing clause in treaties to preserve the benefits of incentive laws to foreign investors. In some tax treaties, double-taxation relief of income is given by tax-credit methods. Under the tax-sparing method, the home country of the investor reduces the taxes on foreign source income by the amount of the taxes already paid, including the tax spared by the developing country under the special provisions of the tax-incentive laws. This can be done by tax sparing or a matching-credit method. 1/

Tax-sparing provisions are comparatively recent and infrequent. Few developing countries do not have any tax-sparing clause in their tax treaties with developed countries.

2. Instances where the developing country has attempted to obtain such a provision, but where the developed country has not agreed to offer such a credit (with comments, if possible, on the apparent reasons for failure to obtain such a clause).

Developing countries pointed out few instances where an attempt to obtain a tax-sparing provision was made unsuccessfully. Sometimes, discussions were initiated with the developed countries to negotiate a treaty including tax-sparing provisions. The developed country asked for compensatory concession in return for tax-sparing concessions.

Many agreements with developed countries were early agreements, and at that time the question of tax holidays, concessions and incentives resulting in giving a relief to taxes spared had not arisen. But since then, the significance of tax holidays and incentives came to play an important role in the economic growth of developing countries.

3. Detailed description of the type of tax-sparing legislation or decree in the host country that leads to tax credit in the capital-exporting country, under the tax treaty, for spared tax.

Most developing countries have legislation which give tax holidays to investors. But tax-sparing provisions in the treaties signed by developing countries are infrequent. In those existing provisions the tax concessions granted to a foreign investor by means of the tax-incentive legislation usually qualify for tax sparing.

4. Description of types of income-tax incentives that the developing country has employed that have not qualified for the tax-sparing credits referred to in No. 1 above.

1/ For instance, in the case of royalties, the developing country reduces the rate at source to below 15 per cent (provided for by agreement) for which the other country grants full credit. If, therefore, the first country levies only a 10 per cent tax, the difference between the agreed rate (15 per cent) and the applicable rate of taxation at source (10 per cent) produces a spared-tax credit of 5 per cent.

Replies have given a detailed description of income-tax incentives. The nature of these incentives varies from one country to another and their purpose remains to accelerate economic development by providing capital formation in the economy.

5. Specific examples of capital imports influenced by the credit for spared tax or other investment-incentive measure given by the capital-exporting country.

Fiscal incentives offered by the developed countries for export of capital and those offered by the developing countries for attracting foreign investment contribute in the opinion of respondents to the increased participation of developed countries in the development programmes of developing countries. However, almost all the replies from developing countries underlined the difficulties of stating with any certainty whether the credit for spared tax and other investment measures given by the capital-exporting countries have specifically influenced the capital imports to developing countries. The replies of members from developing countries pointed out that other factors have an effect on the channelling of capital imports. While it is difficult to trace imports of capital to specific incentives because of the effect of other factors, some replies reported that increased imports of capital from a capital-exporting country can be shown to result directly from the tax-sparing credit in the tax conventions.

6. Brief description of tax incentives other than income-tax incentives offered by developing countries to foreign investors.

Some responding countries have given a detailed list of the tax incentives other than income-tax incentives offered by developing countries to foreign investors. Some of these incentives range from exemption from import and custom duties, export or excise duties to deferral for a few years of the payment of some fees on shared capital payable under domestic laws. Some countries also grant an exemption from rates and property taxes.

7. Estimate of the revenue forgone by the developing country with respect to income that qualifies for the tax-sparing credits provided by developed countries.

There are no adequate statistics available on this question. It has not been yet possible to give actual figures on the amount of revenue forgone by the developing countries with respect to income that qualifies for the tax-sparing credit provided by developed countries. Some replies indicated that a few developing countries are at present undertaking a survey on this matter, and further information will be supplied.

8. Tax-evasion or tax-avoidance aspects, if any, of investment assistance and double-taxation relief, if any, that have arisen under investment.

Most of the replies did not indicate that tax sparing would encourage tax avoidance or evasion. However, one reply pointed to some specific instances of tax avoidance in this area and added general observations on the subject. The reply stated that in one reported case, an existing agreement between a local firm and a foreign enterprise was cancelled and replaced by a practically identical contract so as to bring it within the effective period of a newly enacted incentive measure. In other instances, capital goods exported from a developed country were deliberately overinvoiced, resulting in excessive depreciation

charges in the developing country and, in addition, a loss of foreign exchange that was hidden abroad for the benefit of the buyer of the equivalent. With respect to the possible abuse of treaty relief measures, the reply stated the following:

"Even double-taxation relief can provide scope for tax avoidance or evasion if the facts and figures relating to the claim are not fully and correctly disclosed in the countries concerned. Where tax credit is allowed by a developed country in respect of tax spared in a developing country on the basis of the investment-incentive programmes of the latter, excessive claims cannot be ruled out if the accuracy of the information furnished in regard to the tax spared by the developing country is not properly verifiable. The larger volume of foreign trade following as a result of tax incentives also increases the scope and area of various types of economic offences. But such malpractices in some cases would apparently not justify giving up investment-incentive programmes altogether, which have undoubtedly contributed to increase the operations among the nations of the world in the economic development particularly of the less advanced nations."

The reply recommends increasing the exchange of information between Governments as a remedy for combating the abuses in question. It further observes that where there is a choice between the methods providing the same incentive, the one which gives the lesser opportunity for tax avoidance or evasion should be selected. For example, the exemption method provides considerably less room for false claims than does the credit method. Finally, the reply recommends that a study be undertaken of various types of investment incentives and other tax concessions extended by both developed and developing countries with a view to determining their vulnerability to tax avoidance or evasion schemes. Such a study would also offer suggestions on how to tighten such measures without sacrificing their economic benefits.

9. Other administrative problems, if any, that have arisen under investment assistance and double-taxation relief, including tax sparing.

Developing countries discovered that the main administrative problem is to increase the facilities for exchange of information and verification of information furnished in the course of claims made by taxpayers relating to investment assistance or double-taxation relief. The solution lies in building up an effective machinery for exchange of information and mutual administrative assistance among the countries.

10. Other remarks, if any, arising from the developing country's experience with tax incentives in the developing country (a) with, (b) without a credit for spared tax being given by the investor's home country.

The replies stated that tax incentives are provided by developing countries to attract foreign capital. The operation of the foreign tax credit in the tax laws of the investor's home country, without recognizing the tax spared by the developing country, frustrates the benefits granted by the developing country to the foreign investor in some instances. The result is to shift the revenue from the treasury of the developing country to the treasury of the developed country. If the developed countries agree to give credit under their laws for the revenue forgone by the developing countries as an incentive to foreign investment, the benefits to the foreign investor are secured, and foreign investment in developing countries would become attractive.