Tax treaties between developed and developing countries

Third report
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between developed
and developing countries

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UNITED NATIONS
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Part One

REPORT OF THE AD HOC GROUP OF EXPERTS ON TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES ON ITS THIRD MEETING
# Part One

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INTRODUCTION

A. Organization of the Ad Hoc Group of Experts

TERMS OF REFERENCE

1. The Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries was set up by the Secretary-General of the United Nations in response to Economic and Social Council resolution 1273 (XLIII). The third meeting of the Ad Hoc Group was convened at Geneva from 25 October to 5 November 1971.

2. The task of the Group of Experts, according to the Council’s resolution, is to explore “ways and means for facilitating the conclusion of tax treaties between developed and developing countries, including the formulation, as appropriate, of possible guidelines and techniques for use in such tax treaties which would be acceptable to both groups of countries and would fully safeguard their respective revenue interests”.

3. In resolution 1541 (XLIX) the Council noted 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”; considered that the “mutual accommodation of different 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”; and requested the Ad Hoc Group to continue its work as envisaged in paragraph 1 of resolution 1273 (XLIII).

DOCUMENTATION AND AGENDA

4. A number of working documents and background papers were prepared by the Secretariat with the help of consultants. In addition, a number of papers were submitted to the Ad Hoc Group of Experts by members of the Group and some observers. A list of documents and conference room papers is contained in annex II to this report.

5. The agenda of the meeting was as follows: (a) shipping profits; (b) royalties; (c) dividends; (d) methods for elimination of double taxation (incentives for investment); (e) exchange of information; (f) other problems.

6. The Ad Hoc Group of Experts consists of tax experts and administrators nominated by Governments, but acting in a personal capacity, from both developed and developing countries and representing different regions and tax systems. The following persons were appointed to the Ad Hoc Group: Carlos C. Martinez-Molteni (Argentina); Sangaranpillay Sittampalam (Ceylon); Carlos G. Yacoman (Chile); Helmut Debatin (Germany); Pierre Kerlan (France); A. N. E. Amissah (Ghana); R. D. Shah (India); Simcha Gafni (Israel); Torao Aoki (Japan); W. H. van den Berge (Netherlands); A. Scheel (Norway); Qamarul Islam (Pakistan); Ambrosio M. Lina (Philippines); Hamzah Merghani (Sudan); Kurt Locher (Switzerland); Rachid Sfar (Tunisia); Adnan Basev Kafaoglu (Turkey); J. A. Johnstone (United Kingdom); Nathan Gordon (United States of America). In addition, a number of advisers to the experts participated in the meetings. Observers from Brazil, Finland, Indonesia, Trinidad and Tobago and Uruguay, a specialized agency of the United Nations, several intergovernmental organizations and non-governmental organizations also attended the meetings.

B. Third meeting of the Ad Hoc Group of Experts

OPENING SESSION

7. At the opening of the meeting the representative of the Secretary-General called attention to the fact that there was a proposal before the Ad Hoc Group to establish a permanent panel of experts concerned both with the drafting and with the implementation of treaty clauses in the intricate areas of international income allocation and tax evasion and avoidance. He said that substantial achievements had been made by the Ad Hoc Group in evolving suitable specific guidelines for tax treaties. At the second meeting, another important step had been accomplished, namely, the study and formulation of texts of solutions which had the general support of members of the Ad Hoc Group, particularly on the difficult questions of business profits and interest.

8. At that meeting, the Ad Hoc Group had also paid special attention to a question of particular importance to the developing countries, namely, the way in which tax agreements, particularly clauses relating to exchanges of information, could be used to control tax evasion and capital outflow so as to afford the developing countries access to the

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1 There was insufficient time to discuss this agenda item.
2 Due to lack of time, this agenda item was not discussed in detail. See part two, chaps. VII and VIII of this report.
3 See Tax Treaties between Developed and Developing Countries: Second Report (United Nations publication, Sales No. E.71.XVI.2), part one, para. 141.
means of information available to the developed countries. He further stated that although international tax problems, in particular, the shifting of the burden of double-taxation relief, represented an area of conflicting revenue interests, an extraordinary success had been achieved in that the voluminous technical reports had been adopted by the Ad Hoc Group and endorsed by the Council in resolutions 1430 (XLVI) and 1541 (XLIX).

**ELECTION OF OFFICERS**

8. The Ad Hoc Group elected Hamzah Merghani (Sudan) as Chairman and A. Scheel (Norway) as Rapporteur. Stanley Surrey acted as Special Adviser to the Rapporteur.

**GENERAL OBSERVATIONS**

9. The observer from the International Fiscal Association (IFA) had distributed a resolution adopted by the Conference Congress of the IFA at Washington, D.C., in October 1971; and the report, which dealt in great detail with problems of allocation of profits. The resolution (subject II) recommended that appropriate international organizations, including concerned bodies of the United Nations, study the development of guiding principles relating to the allocation of income and expenses in international transactions between related entities; and that the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries give consideration to the factors involved in allocation questions arising between developed and developing countries.

10. The observer from the Organization of American States (OAS) made a statement concerning the recent work on problems of international double taxation in Latin America and, in particular, in the Andean group of Latin American countries.

11. The observer from the Inter-American Development Bank (IDB) stated that the Bank was very much in favour of the continuation of the useful work done by the Ad Hoc Group and referred to the next meeting of the Bank, which would have the matter of tax treaties between developed and developing countries on its agenda.

12. The observer from the Inter-American Bar Association (IBA) made a statement concerning the work of IBA in the field of international double taxation.
I. SHIPPING PROFITS

A. General discussion

13. The discussion on shipping profits was opened by a member from an industrialized country in which the construction and operation of ships are major industries. He pointed out that the shipping industry was very different from other forms of trade and commerce; and, therefore, had traditionally received special treatment in double-taxation agreements. The basic characteristic of the shipping industry was that its profits were not earned in a specific locality subject to the sovereignty of one or the other Government, but that the activities took place on the high seas outside any territorial jurisdiction. In addition, the profits of the shipping industry depended upon cyclical conditions and unpredictable demands for cargo and transportation of passengers. As that facility was required by international traffic, it was necessary to find means to relieve it from excessive financial worries in addition to its other burdens. For those reasons, tax treaties had traditionally provided for reciprocal exemption of shipping profits, limiting the taxation of such profits to the country in which the place of effective management of the shipping enterprise was situated.

14. Another member from an industrialized country referred to the recent work of the Organisation for Economic Co-operation and Development (OECD) on taxation of shipping. In summary, that work included the following recommendations:

(a) Taxing country. Article 8, paragraph 1 of the OECD Model Convention, which assigns the right to tax profits from the international operation of ships or aircraft to the State in which the place of effective management of the enterprise is situated, shall be preserved. The commentary should clarify, however, that the Contracting States are free, on a bilateral basis, to give the exclusive taxing right to the State of which the enterprise is a resident. Alternatively, the Contracting States may use a combination of the criterion of residence and that of the place of effective management, giving the primary right to tax to the former;

(b) Definition of “international traffic”. As the term “international traffic” is currently not defined in the Model Convention, a number of questions are raised. The working party proposed to clarify the term by including any transport operations by a ship or aircraft operated by an enterprise having its place of effective management or residence in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;

(c) Scope of international operations. The working party recommended to widen the scope of the business of international transportation which comes under article 8 by including rules in reference to a bare-boat charter, when it is an occasional source of income for a shipping enterprise; to container shipments, which have become of increasing importance to ancillary services supplementing international transportation; and to additional activities connected with the operation of ships or aircraft.

15. A member from a developing country pointed out that a much fuller discussion of the taxation of shipping profits would be required in the current meeting inasmuch as industrialized countries fully recognized their obligation to assist developing countries not only financially, but by way of technical assistance. From the standpoint of the developing countries, the mutual exemption of shipping profits appeared to represent a somewhat outmoded approach, especially in view of the foreign exchange problems faced by them. Shipping profits were one very important source of foreign exchange and an apportionment or division of that revenue in the ratio of receipts from a particular country to total receipts was better suited to the problem and, in fact, had been successfully applied. That approach also removed the need for determining the geographical source of specific expenses, which was a definite advantage. In summary, the problem should not be looked at from the point of view of a special interest group or traditional methods, but should be resolved in a manner that would give due consideration to the needs of the developing countries.

16. Members from a number of other developing countries stated that article 8 of the Model Convention was actually a deterrent for developing countries to sign tax treaties inasmuch as it worked exclusively in favour of the industrialized countries. For instance, no consideration was given to the very substantial expenditure that developing countries incurred in the construction of airports and harbour facilities. Further, it would appear more reasonable to place the geographical source of profits from international transportation at the place where passengers or freight were booked. Considering those problems, an apportionment of shipping profits on the basis of turnover would appear to provide a fair solution. One member from a developing country requested clarification concerning the place of effective management in the case of chartered ships, where that place shifted from the lessor to the lessee.

17. A member from a developed country pointed out that the Ad Hoc Group had decided at its first meeting.

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in favour of retaining the principle of reciprocal exemption in the tax treatment of aircraft profits, whereas no agreement had been reached at that meeting in the matter of shipping profits.

18. The Ad Hoc Group recognized that there were two different problem areas, namely: determination of shipping profits; and allocation of such profits to the various countries concerned.

19. There was agreement that profits from the operation of ships could not be derived from the financial statements of the enterprise alone because extraneous factors, such as government subsidies, must be considered. The discussion of the problem at the first meeting of the Ad Hoc Group had left many questions unresolved.

20. With respect to the allocation of profits from the operation of ships, members differed on whether the total profit from the operation should be allocated to the various countries with the help of a formula to be agreed upon, or whether each country affected should independently determine the profit allocable to it—in a manner similar to that in which it would determine the profits of a permanent establishment of a foreign enterprise situated in its territory.

21. Several members from both developed and developing countries expressed themselves in favour of an allocation. One of the reasons for that view was that it precluded inconsistent determinations of income by various jurisdictions, which might have the result that the sum of the portions of income taxed by the various countries would be greater than the entire income, or that a country might tax a profit from operations conducted in its area while the over-all operation showed a loss. The members who adopted that view recognized that the parties to a treaty incorporating that approach might have to agree to certain modifications in the definition of income used in the country of domicile of the enterprise, subject to adjustment for special allowances and incentives. They also were in favour of an allocation formula under which global net profit would be allocated in an agreed manner by applying to it a ratio of gross receipts (outgoing freight) from each country to total gross receipts.

22. Members from several developing countries remarked that the uniform determination of net income might present considerable difficulties in view of the different interpretations of that term in various countries. They expressly hoped, however, that agreement on that question would be reached. The basic difference in the approach of those members from the ones supporting the formula approach was that they insisted on determining net income separately for each country from which profits were derived. A member from a developed country pointed out that absolute precision in the determination of net income would be neither practicable nor even possible. He expressed the hope that a rough approximation would be acceptable, especially as existing differences would balance out among countries and over the years.

23. The principal questions discussed were whether shipping profits should be allocated to the source countries and the way in which to achieve that aim so as to prevent the fragments of shipping income taxed by the various countries from aggregating more than the sum total of income. With respect to the first issue, most members agreed to the adoption of a formula under which net profit, as determined by the residence country, would be multiplied by the ratio of gross receipts from outgoing freight originating in the country to gross receipts on a global basis. One member from a developing country, while agreeing in general with that approach, mentioned the necessity of providing special rates for unusual deductions allowed by the country of residence of the shipping enterprise.

24. The member from a developed country who had opened the debate on the first day pointed out that although his country had taken part 50 years previously in developing a system of apportioning world profits, at that time, apart from other differences, currencies had been stable and depreciation of ships had been computed at a uniform rate of 4 per cent per annum. There had been profound changes in those matters and others since that time. Currently, with prices of ships increasing, changes in price levels could be very disturbing; and many countries that were obliged to maintain merchant fleets were constrained to provide greater depreciation allowances, sometimes in combination with investment credits or allowances, in order to keep their shipping industry viable. For those reasons, the starting-point for calculating profits from the operation of ships should be the world profit of the enterprise as determined at its domicile. If each country to which shipping operations extended were to reopen the question which expenses should be allowed against gross income, the conditions for rational taxation of that income would be destroyed.

25. A member from another developed country considered that a system of allocation might well work out to the benefit of all countries concerned. There remained a question, however, concerning the portion of income that should be reported to and taxed by the home country of the enterprise. A shipping enterprise domiciled in a particular country might well conduct all its activities outside that country, with the result that nothing would be left for the latter to tax, although it contributed capital and management to the enterprise. He suggested that the problem might be handled on a bilateral basis to allocate income to the home country. It was mentioned that in some countries, such an allocation was already provided by the local law or treaties.

26. A different problem was posed by shipping under a flag of convenience from countries that did not impose any tax on their shipping enterprises. The question there is whether the source countries could be expected to rely on a profit allocation made by a country that obviously had no interest in an accurate determination of the profits of its shipping enterprises for tax purposes. Lastly, it must be considered that the determination of taxable income was not always pursued with the same degree of technical skill in all countries. Accordingly, countries negotiating a tax treaty should be free to make
allowance for that situation. There were no ready-made solutions to those problems. It must also be recognized that accepting the principle of allocation was only the beginning and not the end of the deliberations, which should be left to actual treaty negotiations.

27. Members from developing countries pointed out that an over-all net profit figure computed under the rules of the home country could not always be accepted uncritically by the source countries, especially where the home country provided special depreciation, investment allowances or other benefits which might substantially reduce taxable income. Such tax benefits were in the nature of subsidies which should not deprive the source countries of their fair share of the tax. Where the home country did not tax shipping profits or taxed such profits inadequately, the source countries should be permitted to substitute a reasonable estimate of taxable profits for an allocation. It might also be necessary to clarify certain terms in articles such as “gross receipts from freight”, which some interpreted to mean gross receipts without deductions for commissions and similar charges.

28. Another member from a developing country insisted that requiring source countries to accept the profit determination of the home country would violate the principle of sovereignty. Such factors as the low cost of labour in developing countries were apt to distort the allocation, as would the effect given to operating losses sustained in other countries. There might be a possibility of determining the average profits of shipping enterprises; and taxes might be based, for the sake of administrative convenience, on such an assumed profit. The tax so computed would be shared by the home country and the countries of operation.

29. A member from a developed country called the attention of the Ad Hoc Group to the fact that it would be necessary not only to discuss various possible methods of dividing tax revenue between the home country and the source countries, but to define the conditions under which those rules were to be applied. As seen by that member, agreement should be reached on the following propositions:

(a) The home country (place of management) of the shipping enterprise had the right to tax the total profits of that enterprise;
(b) The source countries could tax the profits of the enterprise under two conditions, namely:
   (i) That there was a permanent activity of some kind, such as a permanent establishment or permanent representative, as distinguished from merely occasional contacts in the source country;
   (ii) That there was a sufficient intensity of connexion between the enterprise, as defined in a bilateral tax treaty;
(c) There would be a proper allocation or apportionment of profits which would permit the source country to impose its tax on profits from outgoing freight. The allocation should not exceed that portion of the worldwide profit of the enterprise from shipping operations which the outgoing freight attributable to the source country was of total outgoing freight.

30. A shipping enterprise that considered itself too heavily taxed under that method would be free to invoke the competent authority procedure of the tax treaties.

31. There was some discussion as to whether representatives from developed countries should concede the “right” of the developing countries to tax profits of foreign shipping enterprises, before the working party to be appointed entered into its technical considerations. It was recognized that taxation was a sovereign right of any country, which did not require permission of other countries. The Ad Hoc Group then decided, in an informal session, to appoint a working group and to submit a report on the taxation of shipping profits before the end of the current meeting. One member from a developed country emphasized the difference in the taxation of industrial or commercial profits, on the one hand, and of shipping profits, on the other. He pointed out that special rules accommodating the needs of the shipping industry would have to be devised to prevent putting shipping enterprises in a worse tax position than ordinary business enterprises, which were protected from excessive tax claims of the source country by the permanent-establishment device.

B. Report of the working group

32. The Ad Hoc Group discussed the report of the working group (ST/SG/AC.8/III/CRP.7). A member from a developing country referred to the need to distinguish the operations of shipping lines from those of other business enterprises. Unlike the latter, the taxation of a shipping enterprise in the countries visited by its vessels was not dependent upon the existence of a permanent establishment, considering also that shipping operations were primarily conducted on the high seas. The question concerned the degree of intensity of connexion with the country visited that should be required to justify the latter’s claim to tax. The ship might visit a country repeatedly or it might call only once. But if the single call was a planned operation, the profits from the voyage should be taxable.

33. Another issue to be considered concerned the reconciliation of conflicting tax claims by the source countries and the home country of the ship. The member referred to the situation in which a ship carried freight only from ports in countries other than its home country so that no part of the income could be allocated to the latter, where taxable income was allocated in the ratio of outgoing freight. In order to accommodate the justified expectation of the home country to receive a portion of the tax, some developing countries had reduced their tax on shipping profits to one-half under tax treaties. Through such a concession, the cost of capital and management services provided by the home country was recognized. The member expressed himself in favour of having the home country of the ship determine the total net income, which would then be allocated on the basis of charges for outgoing freight after eliminating extraneous items of income and expense.

34. To a question concerning point 1 of the commentary, it was explained that rules applicable to shipping income would prevail over the provisions of articles 5
and 7 of the OECD Model Convention relating to business profits and permanent establishment.

35. With reference to point 2 of the commentary, it was explained that such items as special (accelerated) depreciation should be characterized as special items or common allowances and should be agreed upon in bilateral treaty negotiations and not be decided categorically a priori. For example, it would deserve to be considered whether accelerated depreciation allowances were substantially due to the need to reflect rapid technological progress.

36. With reference to the certificates referred to at the end of paragraph 2, it was explained that the certificate would be issued by the fiscal administration of the country of residence (effective management).

37. With respect to the special items listed in the last sentence of paragraph 2, it was explained that those items would depend upon actual negotiations because there were always unforeseen situations and the wishes of the parties must also be considered. In essence, the government certificate should clarify those points and identify any special or extraneous items which might be present.

38. Several members from developed countries questioned the wisdom of shipping enterprises being taxed by the countries visited. If the idea of the traditional ratio certificate were to be abandoned, the portion of income taxed by the countries visited might be greater than the whole. Determining taxable income by some arbitrary method would also be inadequate.

39. The Special Adviser to the Rapporteur remarked that two approaches should be considered. One approach was that taken by the OECD Model Convention, which assigned exclusive tax jurisdiction to the country of residence. If that rule were to be abandoned, the question would arise whether the taxation of shipping income should be governed by the permanent establishment concept or whether different rules devised particularly for the shipping industry should be applied. The latter approach was followed in the report of the working group. A member from a developing country remarked that he would be prepared to accept the conclusions of the working group, but that it might be useful also to consider possible alternatives.

40. The discussion then turned to the question of the way in which to treat depreciation allowances and operating losses in the context of shipping income. A member from a developed country observed that the treatment of depreciation in the report of the working group was too imprecise. It should be clarified that accelerated depreciation came under the heading of special allowances; it would also be useful to clarify the distinction between depreciation allowances and outright subsidies.

41. The member pointed out that operating losses were one of the basic factors in the shipping industry and that care should be taken in devising guidelines to prevent the tax benefit of such losses being curtailed by the source country. It obviously would not be right to permit a source country to tax a share of the profits from a particular voyage which had been successful if the over-all operations of the shipping enterprise showed a deficit.

42. There was some difference of opinion on the question whether facilities in the nature of a permanent establishment were necessary to safeguard the collection of taxes by the source countries.

43. A member from a developing country insisted that the countries of call should give consideration to operating losses of a shipping enterprise only for years in which the enterprise had operated in their area. Thus, a loss could be carried over from one year to another, within the limitations of local loss carry-over provisions, if the enterprise had had operations in that country both in the year in which the loss originated and the year to which it was carried. Within that general limitation, the amount of loss would be restricted to the ratio that freight charges attributable to the country of call bore to total freight charges. Thus, if charges for freight dispatched to the developing country amounted to 5 per cent of all freight charges, 5 per cent of the operating loss would be allowed as a deduction. A member from another developing country supported the proposition that each taxable area stood alone. In the matter of operating losses, he emphasized the difference in the treatment of operating loss carry-overs for various countries. Some countries permitted carry-overs without limitation of time, and some permitted carry-backs in addition to carry-overs. The treatment of losses should follow that of taxable income, which also was computed on an annual basis.

44. A member from a developed country pointed out that shipping profits were highly dependent upon the situation of world markets. A shipping enterprise might have a loss in a particular year or might sustain losses over an extended period of years. It would not be fair to shipping enterprises if the country of call were permitted to tax a profit from operations in its area in the face of an over-all loss sustained by the enterprise during the same year or carried over from preceding years. It would be equally unrealistic to hold that each business year stood by itself. Practically all countries had statutory provisions for the carry-over (and sometimes the carry-back) of operating losses because a calendar year was an arbitrary unit of time and it became necessary to equalize profits or losses over a much more extended period. In negotiating tax treaties with developing countries, the member's home country had always assumed that its ratio certificates would be generally accepted. The member further commented on the extraordinary importance of depreciation allowances, considering, in particular, that ships were currently becoming obsolete much more rapidly than they had in the past. Not all countries, even among the seafaring countries, granted subsidies to their shipping enterprises. A member from another developed country pointed out that shipping enterprises were obliged to plan in advance for at least 10 years. In his opinion, it would be entirely illogical to unify the rules on the taxation of shipping profits, but not those with respect to losses. The member from the developing country replied that it would be equally illogical for any country to permit the deduction of losses,
by a foreign enterprise, for a year in which the enterprise had not been engaged in business in the country. There was no practical experience to support such a claim.

45. One member from a developed country remarked that the special nature of shipping income was fully recognized by the Ad Hoc Group. He pointed out that if practically every national tax system permitted the compensation of losses, the same should be done on the international plane. Another member from a developed country preferred to apply the principles of article 7 of the OECD Model Convention if the shipping enterprise maintained facilities somewhat in the nature of a permanent establishment in the country of call. He stated that the existence of such facilities would justify the taxation of the shipping enterprise on profits attributable to the country of operation, notwithstanding that losses were sustained in other countries; and he observed that, contrary to the principles of the Model Convention, the Ad Hoc Group had switched from the direct method of profit determination to the indirect method with respect to the taxation of shipping profits. The member was of the opinion that that distinction was not justified and that paragraph 2 of the commentary included in the report of the working group should be amended accordingly.

46. A member from a developed country concluded that the chances of reaching agreement on the contested points were quite limited at that stage. Therefore, paragraph 2 of the commentary included in the report of the working group should include a statement to the effect that losses of prior years, like the over-all net profits referred to, should be considered in bilateral negotiations.

47. A member from a developing country requested clarification of the last sentence in item 1 of the introduction. He suggested adding the words “such as a percentage of freight receipts”, stating that that addition would be useful in cases in which the home country did not use a ratio certificate.

48. A member from a developed country questioned whether the proposed amendment was within the intended framework of the report. He remarked that the amendment was apt to give too much weight to the statement to which it applied and that readers might be confused concerning the general approach taken by the report. The Special Adviser to the Rapporteur suggested clarifying the point by adding the words “in item 3” after the words “outlined below” in the second line of the paragraph.

49. The member from another developing country proposed adding the words “for the year” after the word “enterprise” in paragraph 2 on page 2 of the report (before the commentary). A member from a developed country pointed out that the report was couched in very general terms and deliberately omitted specific reference to one or the other person or period of time. An uninformed reader of the report might wonder just why the language was so specific in one part of the report and not in others. The report was meant to supply only principles whose practical application would be worked out in treaty negotiations.

50. After some discussion, the Ad Hoc Group decided on certain changes in paragraph 2 of the commentary. The word “considered” would be substituted for the word “included” in the fourth sentence because the question properly concerned the exclusion, as well as the inclusion, of direct subsidies. The same change would be made in the penultimate line of paragraph 2. In the fifth sentence, the words “if any” would be inserted both after the words “recognition of losses” and after the words “determination of net profits”. Another member suggested inclusion of the phrase “including losses if so decided in negotiations” after the words “and the amounts of any special items” in the same sentence. Another member from a developing country required clarification with respect to the method of recognition of losses (commentary, paragraph 2, sixth sentence). Such losses should be considered only from the time shipping operations commenced in the country so as to prevent income from that country being reduced by losses sustained in other countries. To an objection that that method would require splitting up a ratio certificate between various portions of a year, a member replied that the relevant point of time would be the year of the ship’s arrival without reference to any specific dates.

51. A member from a developed country with major shipping interests pointed out that it would not be advisable for the Ad Hoc Group to engage in highly technical discussions with respect to operating losses. Unlike the situation prevailing in other businesses, heavy operating losses were a characteristic feature of the shipping industry, which was at the mercy of business cycles which often lasted for extended periods. The same approach should be taken with respect to depreciation. In essence, depreciation charges reflected the amortization of capital tied up in the ship, and there must be adequate write-offs to provide the capital for subsequent replacement of the vessel.

52. A member from a developed country reiterated, citing international agreements preceding the OECD Model Convention of 1963, that shipping income should be exempted in the source country. Other members stated that that point was considered in paragraph 2 of the introduction to the report of the working group, and that while the member’s point of view had been generally accepted 30 or 40 years previously, his own country had, in the meantime, signed treaties based on the opposite point of view. One member pointed out that out of 28 tax treaties between developed and developing countries which he had examined, 11 adopted the approach of the OECD Model Convention. With respect to the question of allocation of profits (commentary, page 2, paragraph 3), one member stated that he would prefer to rewrite the parenthetical clause as follows: “with or without commissions but concluded on a uniform basis”. Another member suggested reversing the sequence of paragraphs 1 and 2 of the commentary. One member proposed the addition of the words “and the taxing rights of the source country” after the words “sharing of revenue” on page 3, paragraph 4 of the commentary. It was pointed out by other members, however, that it was the purpose of the sentence to give equitable consideration
to the contributions made by the residence country and that the taxing right of the source country was not the issue.

53. Another member suggested inserting the words "to widen" on line 5 of paragraph 5 of the commentary, before the words "the scope of shipping"; there was no objection to that proposal.

54. The meeting then went into an extended discussion of government subsidies paid to shipping enterprises, which had been discussed by the working group. Most members apparently were of the opinion that the matter was one for negotiations because government grants might or might not be required to be included in taxable income, depending upon the legal nature of the grants. Apart from different rules on this point in various countries, those domestic rules were not necessarily binding internationally.

55. It was pointed out that once subsidies were includable in taxable income in the home country, they would automatically become part of the allocable profits included in the ratio certificate and thus become subject to taxation by the source countries. The same result might obtain if subsidies were considered income without being taxed in the home country. In either case, the taxation of parts of such profits by the source country could be prevented by suitable treaty arrangements.

56. Several members from developed countries took exception to the inclusion of subsidies (as distinguished from other types of benefits, such as special allowances or airmail transportation privileges) in taxable income. They stated that subsidies, in the real sense, should be treated as being entirely outside the area of taxation and should be properly regarded as a gift or windfall. They insisted that no country had a right to levy a tax on payments that another Government was making to keep one of its important industries alive. In fact, such a step would amount to taxing the Government of the home country. Representatives from several source countries conceded that that issue could be resolved in bilateral negotiations. One member from a country with a major shipping industry was of the opinion that subsidies should never be included in income subject to allocation, regardless of whether the home country treated subsidies as taxable income.

57. The Ad Hoc Group concluded the discussion of shipping profits. It accepted the proposal of a member from a developed country to rewrite the fourth sentence in paragraph 2 of the commentary as follows: "in appropriate cases the negotiations may also state that direct subsidies paid to the enterprise by the Government should be included in net profits". A member from a developing country suggested that the last sentence in paragraph 2 of the introduction (page 2, before the commentary) be rewritten to state that "the tax computed in accordance with such allocation may then be reduced by an appropriate percentage".

58. The Ad Hoc Group then discussed whether taxation on the basis of charges for outgoing freight was the appropriate solution. Members agreed that that method of taxation was adequate where a ship carried freight both ways. Differences of opinion existed where merchandise was transported only from one country to another. One member from a developed country questioned whether the country of embarkation should have the right to tax the entire income from the voyage, considering that by far the greater part of the transportation service was rendered on the high seas. It was also mentioned that the home country would be deprived of all tax under that system where all freight was dispatched from other countries. Members from developing countries replied that they gave recognition to that situation by reducing the amount of taxable income or tax or by acknowledging the contribution of the home country by way of capital or management services. One member from a developed country emphasized that shipping services were, for the most part, rendered outside any territorial jurisdiction and that, consequently, the connexion of the shipping enterprise with the port of loading was considerably more tenuous than the business connexion through a permanent establishment in the case of other enterprises. Accordingly, the home country of the ship should have the primary right to tax. The member also declared himself in favour of the specific reference to a 50 per cent reduction of the tax of the source country (commentary, page 3, item 4). That reference had been requested by other members so as to provide practical guidance to Governments not represented at the meeting. The member was also of the opinion that the first sentence in the paragraph referred to should describe the specific nature of shipping income.

59. With respect to the percentage reduction to be applied by the source country, members compared the situation in which the ship did not load any freight in the home country and the situation in which it loaded some freight there. The question was whether the percentage reductions of income or tax should be different in the two situations. Considering that no income was allocable to the home country in the first case and only a limited amount of income was allocable in the second case, there was some difference of opinion as to whether a fixed or variable percentage should be used. There was some support for amending the last sentence of paragraph 2 of the introduction (before the commentary) to state that "the tax computed in accordance with such allocation shall then be reduced by an agreed percentage in appropriate cases"; meaning the cases described in paragraph 4 of the commentary. Some members expressed a preference for simply referring to paragraph 4 in view of the indefiniteness of the term "appropriate cases". Members also differed on the question whether the amendment should read "shall then be reduced" or "may then be reduced". The members agreed to settle the question by adding a foot-note to the last sentence in paragraph 2 of the introduction, reading: "Some members were of the opinion that such a reduction would not be appropriate in all cases".

C. Conclusions on shipping profits

60. Some developed countries, after examining the alternative approach suggested, still preferred the approach of exclusive taxation by the country of residence (effective
management), for the reasons advanced at the first meeting of the Ad Hoc Group. Other developed countries appeared not to be adverse to that type of treaty. In the discussions, it appeared that nearly all the other developing countries desired a treaty in which shipping activities might be taxed at source, so to speak, rather than exclusively in the country of residence (effective management).

61. The approach outlined was an appropriate method of taxing shipping profits by a country, other than the country of residence (effective management), in which shipping activities were conducted (generally called "source countries"), if such taxation was to be decided upon in a bilateral negotiation. Most of the countries that desired to tax such shipping profits at source appeared to favour using that method in negotiations. It was understood, however, that if a source country did not desire to use that method of taxation at the source, it could in a negotiation, seek to work out a different method, such as a percentage of freight receipts.

62. The approach developed as an alternative to the method of exclusive taxation in the country of residence (effective management) is given below.

**ALTERNATIVE APPROACH TO TAXATION OF SHIPPING PROFITS**

**General text**

63. Profits from the operation of ships in international traffic might be taxable in the country in which the place of (residence) (effective management) of the enterprise was situated.

64. Profits from the operation of ships in international traffic might also be taxed in a country in which shipping activities that were more than casual were conducted. The profits to be so taxed should be determined on the basis of an appropriate allocation of the over-all net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation should then be reduced by an appropriate percentage.

**Commentary**

65. Taxation of shipping profits in a source country was based on an operative rule for the shipping business and was not qualified by the provisions of articles 5 and 7 relating to business profits governed by the permanent-establishment rules. It thus covered both regular or frequent shipping visits and irregular or isolated visits, provided the latter were planned for and not merely fortuitous in the circumstances. The phrase "more than casual" connoted a scheduled or planned visit of a ship to a particular country to pick up freight or passengers.

66. The over-all net profits should, in general, be determined by the authorities of the country of residence (effective management) of the enterprise. The final conditions of the determination might be decided in bilateral negotiations. Such negotiations, for example, might state whether the net profits were to be determined before the deduction of special allowances or incentives, not falling within a method of allowances for depreciation, but being in the nature of a subsidy to the enterprise. In appropriate cases, the negotiations might also state that direct subsidies paid to the enterprise by a Government should be included in net profits. The method of recognition of losses, if any, of prior years, for the purpose of the determination of net profits, might also be worked out in the negotiations. In order to effectuate the above-stated approach, the country of residence (effective management) would furnish a certificate stating the net profits of the enterprise from shipping and the amounts of any special items, including prior losses, which it was decided in the negotiations were to be included or excluded in the determination of the net profits to be apportioned or otherwise to be specially treated in that determination.

67. The allocation of profits to be taxed might be based on some proportional factor specified in the bilateral negotiations, preferably the factor of outgoing freight receipts (determined on a uniform basis with or without the deduction of commissions).

68. The percentage reduction in the tax computed on the basis of the allocated profits was intended to achieve a sharing of revenues that would reflect the management and capital of the residence country (effective management) devoted to the enterprise.

69. It was understood that the OECD Committee on Fiscal Affairs was giving consideration to recognizing the freedom of countries wishing to do so to substitute the criterion of "residence" for that of the "place of effective management", or to combine the two criteria in certain specific circumstances, to clarify the definition of "international traffic", and to widen the scope of "shipping" in the light of technological and other developments. Such consideration, on the basis of current reports, appeared to be a useful development.

70. In general, when a ship was leased on a bare-boat basis, the income from the lease was not governed by article 8, but the income from the lessee's operation was governed by that article. The OECD Committee on Fiscal Affairs was understood to be considering the application of article 8 to occasional income obtained through bare-boat leasing by a lessor enterprise engaged in the international operation of ships.7

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7 See annex III for notes supplied as background explanation of their points of view by some members of the working group, from developing countries, during the working group discussion.
II. ROYALTIES

A. General discussion

71. At the beginning of the discussion of royalties, the Secretary referred to the general discussion of that topic that had taken place at the first meeting of the Ad Hoc Group of Experts.8 At that meeting, royalties had been discussed together with interest. The following topics were listed: (a) the scope of royalties; (b) the question which country should tax royalties; (c) the net or gross basis of taxation; (d) the way in which the patent exporting country should relieve double taxation.

72. On the scope of royalties, a paper had been distributed at the second meeting.9 On the other issues, a statement by the member from India 10 had been distributed at the second meeting; and statements by the members from Israel (ST/SG/AC.8/III/CRP.1) and the Philippines (ST/SG/AC.8/III/CRP.5 and Add.1), were distributed at the current meeting. A paper on taxation of royalties received by non-residents under the laws of selected developing countries 11 also had been distributed at the second meeting, and a paper on taxation of royalty payments by licensees in developing countries 12 was distributed at the current meeting.

73. The Ad Hoc Group then discussed the subject of royalties. A member from a developing country remarked that the OECD Model Convention gave the exclusive right to tax royalties to the licensor’s home country—in practical effect, to the developed countries. From the point of view of the developing countries and in order to facilitate the conclusion of tax conventions between those countries and the developed countries, the primary right to tax royalty income should be given to the country where that income arose, i.e., the domicile of the licensee. As far as could be seen, only Singapore had adopted the rule of the Model Convention in its treaties. The extension of tax concessions to industrialized countries should be left to the discretion of the developing countries and not be prejudged by a blanket exemption of royalties in the source countries. The points made by the member were supported by members from certain other developing countries.

74. A member from a developed country called the attention of the Ad Hoc Group to certain agreements reached at the first meeting. As indicated in the report of that meeting, it had been agreed that royalties should be treated in the same manner as interest, namely, that the revenue should be shared by the countries affected.13 The member assumed that that solution still reflected the intent of the Ad Hoc Group.

75. A member from a developing country observed that the first point listed included a number of topics that should be spelled out and that the third point required detailed consideration of allowable deductions. With respect to this point, the member remarked that patents and processes were usually licensed to developing countries after they had been fully exploited elsewhere. While it would be going too far to assert that such properties were made available to developing countries at a time when they had become obsolete, it would be no overstatement to say that they arrived at a late stage when the cost and expenses incurred to develop them had been largely recouped. Most of those cost and expense items originated at the development stage and very few were incurred thereafter. Granted that the source country had the right to tax, the question remained concerning the method of computing the tax base. If royalties were to be taxed on a net basis, specific rules would be needed to determine what expenses—other than those incurred in the developing country—should be allowed as deductions, especially in view of the extravagant claims often made by licensees. Such questions must also be considered in setting the tax rate on gross income, considering that gross income was the same as net income if all expenses had previously been written off. There was no merit to the assertion that the tax rates of the developing countries were often much too high. Lastly, it should be considered that patented articles usually commanded a higher price than unpatented merchandise; as a result, royalties based on the sales price of a patented product were correspondingly higher.

76. A member from a developed country pointed out that his experience had been very different. Manufacturing enterprises knew that only a fraction of the patents developed by them would be successful, but they could not in advance identify the successful patents. Accordingly, it was unrealistic to think in terms of individual patents only. In reality, a business enterprise would survey the market, determine which products were salable and then invest in research activities, which were notoriously costly. With some luck, those activities would result in a patent to which the entire research and development expense incurred would be properly allocated. It would also be unrealistic to assume that enterprises

8 See Tax Treaties between Developed and Developing Countries, First Report, part one, paras. 92-97. For analysis of treaties, ibid., part two, paras. 79-95, dealing with both royalties and film rentals.
9 See part two, chap. III, of the present report.
10 See part two, annex II, of the present report.
11 See part two, chap. II, of the present report.
12 See part two, annex I, of the present report.
13 Tax Treaties between Developed and Developing Countries, part one, para. 93.
selected the oldest patents for licensing to developing countries. Normally, an enterprise would license its patents to foreign subsidiaries and therefore select the most up-to-date inventions, in the hope of expanding existing markets or opening new ones. For those reasons, the developing countries should tax royalties at a reasonable rate and on a net basis. The member remarked that the discussion would be greatly furthered if it were realized that patents were not merchandise, but instruments for promoting industrial production. Both speakers agreed that a special rule was needed for the treatment of lump-sum payments made by the licensee in consideration of development expenses incurred by the licensor. Such payments were currently contracted for to an increasing extent, in addition to current royalties.

77. It was also pointed out that film rentals should be separated from royalties for tax purposes because of the special problems presented by them.

78. Other members from developing countries suggested differentiated tax rates applying to royalties, depending upon the age of the patent, considering that the cost of older patents was largely already written off.

79. A member from a developing country proposed that the exclusive right of taxation should be granted to the country paying the royalties when the latter concerned the use of fully written-off patents or licences.

80. It was pointed out by a member from a developed country that the total write-off of costs and expenses by the time the patent was licensed to a party in a developing country did not necessarily support the latter's claim to exclusive taxation of the royalties. Irrespective of the amortization methods applied, industrialized countries were generally prepared to allow write-offs over short periods, both to encourage industrial research activities and because the useful life of a patent and the spread of income over that life were scarcely ever predictable in advance. If the country in which the patent had been developed permitted the deduction of cost and expenses incurred in developing the patent, it reduced its tax claim and accordingly bore a substantial share of the development cost. It would therefore not be right to let the licensor's country collect all or most of the tax from that source. In addition, it was clearly difficult or impossible for the source country to determine the amount of development cost and expenses incurred over a period of years—it was quite difficult even for the licensor's country of residence to make that determination. Therefore, consideration should be given to an arbitrary determination of taxable income.

81. Some members from developing countries agreed with that view, but pointed out that it would be necessary to clarify the principles on the basis of which a compromise could be reached. In formulating such an agreement, consideration should also be given to administrative convenience, as well as to the justifiable expectation of taxpayers of not being harassed by many inquiries by the officials in the other country. The important point, in the view of those members, was the determination of the tax base. The problem would be greatly simplified if an arbitrary basis of a percentage were adopted, thus obviating the need for identifying specific expenses.

82. A member from a developed country, while expressing himself in favour of the exclusive taxation of royalties at the licensor's domicile, conceded that, to arrive at a solution, a compromise should be found between that point of view and the opposite approach taken by some developing countries. The member proposed the division of tax jurisdiction between the licensor's home country and the source country by giving full taxation rights to the former, but permitting the latter to levy a withholding tax of 5 per cent on the gross amount of the royalties. The member pointed out that support for such a solution could also be found in the commentary to the OECD Model Convention (see page 120). Considering that a 5 per cent tax on gross royalties was the equivalent of a 10 per cent tax on net income, if expenses were 50 per cent of gross income, the member asserted that the solution proposed by him was both equitable and practical because it avoided the difficulties inherent in the determination of net royalty income.

83. A member from a developing country stated that the definition of the term "royalties" in article 12 of the Model Convention was in need of revision in view of the substantial technological advances made in the previous decade. He referred in that connexion to the substantial payments made by enterprises in his country in consideration of the transmission of technical knowledge and skill, especially in the area of data processing.

84. After some argument about the sequence of topics to be discussed, the Ad Hoc Group decided to defer the problem of defining the term "royalties" and to prepare guidelines for the determination of rules for the taxation of royalties. It was pointed out by the Special Advisor to the Rapporteur that the problems presented in that context were not unlike those which the Ad Hoc Group had discussed at its second meeting with respect to the taxation of interest. The question was whether the principles developed there could be applied to the more conventional types of royalties, leaving out film rentals, copyright royalties and possibly other items in that general area requiring special treatment. One member requested an explanation of the reasons why film rentals etc., should be distinguished from royalties. He found that the combination of industrial royalties, copyright royalties, film rentals and payments for "know-how" given in article 12 of the Model Convention was a good solution. If members felt otherwise, it would be necessary both to devise special rules for individual types of royalties and to explain the reasons for such special rules. If that should be the sense of the meeting, it would be necessary to appoint a special working party to deal with those matters.

85. A member from a developed country strongly supported the point of view expressed by the Special Advisor to the Rapporteur. With respect to the alleged similarities between the rules on the taxation of interest and those on the taxation of royalties, the member pointed out that there were basic differences between the two. Interest

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14 See Tax Treaties between Developed and Developing Countries: Second Report, part one, paras. 105-113.
was compensation for the use of money, whereas royalties included compensation for a capital outlay in addition to current revenue. Accordingly, a withholding tax on royalties and a withholding tax on interest, both at the same nominal rate, were not comparable because the former constituted a greater burden on the yield from the property. Therefore, the rate of the withholding tax on royalties should be set at a lower level than that of the withholding tax on interest.

86. The member further pointed out that business enterprises needed definite assurance concerning the maximum tax on royalties to which they might be exposed in the foreign country. That assurance was needed, among other reasons, for the purpose of realistic profit computations and in order to decide whether or part of the tax could be passed on to the customer. Those facts were strong arguments in favour of computing the tax on the gross amount of the royalties, and it was no coincidence that that method was applied in numerous tax conventions.

87. After some discussion, the meeting decided to request the Secretariat to draft guidelines on the taxation of royalties based on those set forth in the second report for the taxation of interest.

B. Report of the working group

88. A paper (ST/SG/AC.8/III/CRP.8) prepared by a Special Advisor to the Rapporteur in which paragraphs 105 et seq. of the second report were adapted to the taxation of royalties, was submitted to the meeting. That document deviated from the report in the second sentence of paragraph (b) and paragraph (c).

89. A member from a developing country emphasized that there had been no agreement at the preceding session concerning the application to royalties of the guidelines agreed upon at the second meeting. In his opinion, royalties required separate consideration, especially for the purpose of arriving at an equitable apportionment of cost. An intensive study of that subject, as suggested in the report of the first meeting of the Ad Hoc Group, was still needed. Such a study should also include detailed statistical analyses because decisions in the matter should be made on the basis of objective facts and not mere opinions. The study should also consider the age of patents licensed to developing countries.

90. A member from a developing country raised several questions with respect to the paper submitted by the Special Adviser. He asked, in particular, who would decide the questions in reference to the certainty in the application of a withholding tax and the facilitation of its administration (section (c)) and what criteria would be applied in making the determinations referred to in section (b) of the statement. In addition, apart from such detailed matters, which should be carefully re-examined, the member questioned some of the arguments put forward concerning the computation of the proper tax rate in the source country. The member explained that every entrepreneur must necessarily calculate his expenses and the charges to be made to his customers to arrive at a reasonable profit figure. As a result, the expenses to be charged against royalty income were in fact, predetermined in the licensor's home country before the patent was licensed abroad. In addition, there had been changes over the years in the nature of withholding taxes. Withholding of tax at the source had originally been merely a collection device. Currently, withholding taxes imposed on certain income of non-residents were actually in the nature of a final assessment because the detail of cost and expenses incurred to acquire the income was almost never available to the tax-collector in the source country. Accordingly, such withholding taxes were computed on gross income. The fact that withholding taxes were frequently reduced under bilateral tax treaties simply reflected the fact that a tax treaty was an agreement covering a multitude of different points in which mutual concessions were made by both parties. Considering those facts, the member was of the opinion that the importance of actual expenses might be somewhat overstated in the paper submitted by the Special Adviser.

91. A member from another developing country agreed with the view that film rentals and natural resources royalties merited special treatment, as pointed out in the first report. Eliminating those special items, the member was of the opinion that the guidelines provided by the second report in the matter of interest might well be utilized in the area of royalties, especially since paragraph (a) of the paper prepared by the Special Adviser accepted the proposition that the revenue from royalties should be shared by the home country and the source country.

92. The member emphasized that the determination of the tax base was the crucial problem. Understanding had been reached among the members that it was not possible to attribute research and development cost to any specific patent. The patent holder must obviously be permitted to deduct all costs incurred by him. Otherwise, the unabsorbed cost would be reflected in the price charged to the licensee. The member also referred to the foreign-tax credit problem faced by the licensor if the effective tax rate of the source country exceeded the tax rate of the home country. Even a moderate rate levied on gross income could well reach a higher amount than the regular rate of the home country on the true net income involved, the exact difference being determined by the ratio of expense to gross income.

93. As seen by a member from a developed country, one basic difference of opinion concerning the proper tax rate to be applied by the source country existed between those who believed that the local corporate tax rate was the proper one and others who advocated a lower rate. The member asked whether, supposing that all research and development expenses were fully absorbed in the home country, a developing country would treat the royalty income derived in its area as gross

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15 See Tax Treaties between Developed and Developing Countries, First Report, part one, para. 97.
16 Ibid., part one, para. 92.
income and, as such, taxable according to its rules, or as a recovery of cost for purposes of its own tax. The member from the developing country to whom the question was put replied that, apart from special cases in which revenue should be shared, the source country should have the exclusive right of taxation. Being fully aware of the fact that the agreements reached at the first meeting of the Ad Hoc Group were in the nature of guidelines only and not draft treaty provisions, the question remained whether those agreements were still considered valid by the members. The member further asked for clarification concerning the manner in which the source country would be expected to reduce its withholding rate, as suggested in paragraph (d) of the paper submitted by the Special Adviser. The member expressed himself in favour of a flat withholding rate computed on gross income, such as the 5 per cent rate suggested earlier. A higher withholding tax would be used if applied to income.

94. Several members from both developed and developing countries expressed their general agreement with the statement prepared by the Special Adviser, which should, however, be considered merely another guideline expressing general ideas which might be utilized in bilateral treaty negotiations.

95. Concerning revenue-sharing, some members from developed countries were of the opinion that it was one of the "basic principles" concerning the taxation of royalties, which, according to the agreement among members reached at the first meeting were similar to those applicable to interest. In view of the various opinions expressed at the current meeting, the members believed that a reaffirmation of that consensus by the members would be helpful. In the opinion of those members, it would not be advisable for the Ad Hoc Group to agree on a definite rate of withholding tax, such as 5 per cent of gross royalties, as had been proposed. A member from a developing country wanted it understood that tentative agreements on certain points reached during preceding meetings of the Ad Hoc Group were in no sense prejudicial to a reconsideration of the same issues. He considered that it would be entirely inappropriate for the Ad Hoc Group to go into such detail as consideration of withholding tax rates.

96. Another member from a developing country pointed out that the discussion of the subject-matter had thus far dealt exclusively with industrial royalties. The tax imposed on royalties was clearly one of the factors considered by businessmen in setting the rate of a royalty in order to know the amount of their net profits after payment of tax. If the tax rate was high, the amount of the royalty was likely to be increased. Royalty rates varied from country to country, from time to time and often from product to product. Accordingly, it would be quite unrealistic for the Ad Hoc Group to discuss that issue as if conditions were substantially similar in all countries, and to pre-empt the decision on questions that were the very substance of bilateral negotiations. That point deserved special emphasis, especially for the benefit of developing countries not represented at the meeting. Those countries should also be cautioned to consider what expenses had already been deducted in the licensor's home country before deciding on the types of expense that they would permit to be deducted. Since the nature of expenses varied, it would be preferable to settle the deductibility of one or the other expense on the occasion of treaty negotiations.

97. A member from a developed country reiterated that there was no logical connexion between the mass of research and development expenses incurred by a business enterprise in embarking on the production of a new product or line of products, and the specific invention that happened to be successful. Since a business enterprise developing a number of patents could never know in advance which of them would be successful, the research and development cost could never be attributed only to the successful patent or patents.

98. Again on the subject of revenue-sharing, a member from a developed country mentioned that among the various factors to be considered were differences in the taxation levels of home countries and source countries. If the tax of the home country was high, the licensor in that country was in a position to absorb a higher source tax. In the reverse situation, the entire tax of the home country might be wiped out by the tax of the source country so that, in effect, the power to tax that income was shifted to the latter country. In exceptional cases, a tax treaty assigned the exclusive right to tax royalty income to the source country. The member pointed out that the 5 per cent tax rate on gross income suggested by him also found support in the OECD Model Convention and that that method of taxation was superior to computing the source country tax on net income, in view of the difficulties in determining the tax base.

99. The observer from the Organization of American States called the attention of the meeting to the work on a model convention being prepared by six Latin American countries in the Andean Group. According to the suggestions made by that group, royalties were to be taxed where the invention or patent etc. was utilized.

100. A member from a developing country pointed out that according to the practice followed by his country, a tax treaty should not provide more favourable treatment to residents of one treaty country than that granted to residents of other treaty countries. Accordingly, it was important to develop generally acceptable guidelines from the beginning.

101. A member from a developing country remarked that no framework for the discussions had been set by the Ad Hoc Group. After such policies had been adopted, the members could turn to studying procedures and mechanisms for the avoidance of double taxation in agreement therewith. As set forth by the member, the basic questions were: (a) whether royalties should be taxed at all; (b) if so, whether the right to tax should be in the home country or the source countries; (c) whether the tax should be computed on gross or net income.

17 Ibid., part one, paras. 89 and 93.
18 Ibid., part one, para. 95.
19 Ibid., part one, para. 84 (c).
102. The Ad Hoc Group requested the Rapporteur, assisted by the Special Adviser, to prepare a general summary of the views on royalties reflecting their principal arguments.

103. The paper summarizing the discussion on industrial royalties (ST/SG/AC.8/III/CRP.9) was then discussed. A member from a developed country requested clarification of the words “on account of development expenditures” in the first sentence of the paragraph before item 5 on page 4 of the summary. He explained that payments “on account of” were generally understood in English law as denoting partial lump-sum payments over and above current payments for royalties etc. Since the size of the payments was not relevant, the conclusion would be, in terms of the sentence referred to, that even minimal payments on account would not enter into the determination of allocable expenses. The Special Adviser to the Rapporteur explained that the term “on account of” was not intended to be applied in that sense and should be understood as synonymous with the term “with respect to”.

104. A member from a developing country pointed out that it would be desirable to clarify the status of lump-sum payments because their implications had not been discussed. He explained that some source countries taxed lump-sum payments, at least if they were made in their area, while others did not. A lump-sum payment might represent the entire payment for the use of an intangible, it might be one of several payments, or it might be a part of current royalty payment. Because of the very different significance that such payments might have, his country followed the practice of having a committee of government officials assess the nature of such payments in connexion with the approval of licensing agreements. The member further suggested the substitution of the word “equitable” for the word “proper” in the fourth line of item 4, paragraph 1 on page 2 of the summary. According to him, the word “proper” meant “in accordance with law”, which apparently was not the meaning intended by the sentence referred to. The Special Adviser proposed solving the problem by striking out the word “proper” because the term “equitable” also had connotations that were not intended.

105. A member from a developing country complained that no attention had been given in the summary to the taxation of royalty payments between related enterprises. The Special Adviser assured him that that problem would be considered in its proper context.

106. A member from another developing country questioned the use of the term “net royalty” or “net income” on pages 2 and 5 of the summary because the deductions used in arriving at net royalty income had not been defined. Another member considered that the wording of item 4 on page 2 of the summary was misleading inasmuch as withholding taxes were imposed on gross royalty income and not on net income. The Special Adviser pointed out that that point was considered in general form under item 3 (a) on page 1 of the summary and that it might be advisable to clarify in the opening sentence of item 4 that only item 3 (a) was discussed there. He requested the members to delete paragraph 7 on page 7 of the summary.

107. For the benefit of the members, the Special Adviser to the Rapporteur explained the arrangement of the material in the paper (ST/SG/AC.8/III/CRP.9). He explained that in item 3, two different subjects were discussed. The first was whether the source country should give recognition to the effect of expenditures; that point was covered in item 3 (a) and more fully in item 4. The second point, which concerned the methods of taxing royalties, was covered in item 3 (b) and discussed in item 5. The question of sharing of tax between the two countries concerned was discussed in item 6. That was a subject for negotiations between countries because the discussion made it evident that some members were in favour of sharing and others were not.

108. A member from a developing country proposed to substitute the word “fair” for “proper” or “equitable” in the first paragraph of item 4 on page 2 of the paper under discussion. The Special Adviser felt that “fair” was no more precise than “proper” and reiterated his former proposal to strike out the original term without substitution. There was substantial agreement that paragraph 2 of item 4 should be deleted.

109. A member from a developing country expressed some dissatisfaction with the course of the discussion. A member from another developing country expressed the view that the second paragraph of item 4 was confusing. Members had agreed on the right of the developing country to tax, but had also considered the necessity to consider expenses. He reminded the members that the Ad Hoc Group had begun with article 12 of the OECD Model Convention. Representatives from developing countries had then considered three changes to the text of the model article: (1) exclusion of film rentals and other rentals; (2) attribution of the right to tax to the licensee’s country as distinguished from exclusive taxing rights of the licensor’s country; and (3) administrative problems concerning the collection of taxes (withholding taxes).

110. Item 4, paragraph 2, dealt with the issue of how to determine taxable income in the source country and not with the issue of revenue-sharing, which was discussed quite satisfactorily in item 3. A member from a developed country objected to the deletion of paragraph 2 of item 4 for the reason that the statements made there reflected discussions that had been held during the meetings and that the record thereof should not be lost.

111. A member from a developing country stated that the paper (ST/SG/AC.8/III/CRP.9) did not faithfully reflect the actual discussions held. He stressed that he, as well as other members, had expressed himself clearly in favour of exclusive tax jurisdiction of the source country in the matter of royalties. That important point was not reflected in the paper under discussion. If it was true that developing countries could expect substantial assistance from industrialized countries, there was no merit in a tax system that gave with one hand and took away with the other. There were also other arguments in favour of the exclusive taxing right of the source
country. The firm that had developed the patent or process in the industrialized country fully recouped its expenses in that country; therefore, burdening the developing countries with such expenses meant, in effect, a duplication of revenue. If the developing countries felt inclined to apply a selective policy of exemptions to attract needed technology, the decision thereon should not be prejudiced by unsuitable rules of taxation.

112. The Special Adviser to the Rapporteur suggested that the point made by the member was actually considered on page 3, first paragraph, of the paper, but that different language might be inserted on page 6 to clarify that some countries favoured exclusive taxation of royalties at the source.

113. Some members objected to the use of the term “general agreement” in various parts of the paper, such as in the first line of item 4 on page 2; and in the fourth line on page 3. Some members appeared to feel that the term denoted unanimity of views, while others were of the opinion that it could be read as indicating majority consent. Those objections were directed, in particular, to the first sentence of item 4 on page 2. The Special Adviser stressed that the term used by him was not intended to mean either uniformity or preponderance of views, but he offered to rewrite the sentence as it obviously had caused some confusion. He reminded the members that it was not the purpose of the Ad Hoc Group to decide on ultimate methods of taxing royalties and that the question was whether expenses should or should not be considered by the country of source. Upon the suggestion of a member from a developing country to substitute the words “agreement on the desirability of the taxation of the net royalty” in the second line of item 4 on page 2, the Special Adviser referred to item 6 on page 6, in which the members’ views were fully reflected.

114. A member from a developing country supported the desirability of exclusive taxation of royalties in the source country by referring to the practice of some licensors to canalize royalty payments through tax haven corporations. A member from a developed country questioned that view on the ground that source countries would usually not grant exemption in favour of dummy companies in tax haven countries, unless there was a tax treaty between the two countries, which again was not very likely.

115. The Special Adviser observed that there was considerable merit in both views expressed and that they were not irreconcilable. While it was true that tax haven countries, in the technical sense, were, in general, outside the orbit of tax treaties, the view expressed by the member from the developing country was quite correct inasmuch as any country that had no income tax or only a minimal income tax was a natural target for certain investors to canalize royalties. Tax administrators were, accordingly, concerned about countries that allowed low tax rates or exemptions in favour of royalties. There could also be concern that treaties allowing low tax rates or exemptions should be carefully structured, as there were tendencies to utilize treaties between more than two countries to eliminate any tax on royalties. The member from the developing country retorted that the best remedy against tax evasion would be taxation at the source. He considered, however, that expenditures incurred in the licensor’s home country should, on principle, be allowed.

116. The Ad Hoc Group then renewed discussion of the deduction of lump-sum payments, covered in the last paragraph before item 5 on page 4 of the paper (ST/SG/AC.8/III/CRP.9). A member from a developing country proposed to rewrite the last sentence in that paragraph to read that no deduction would be allowed in the developing country for lump-sum payments predicated on development expenses and that only current expenses incurred in the source country would qualify for deduction.

117. In the opinion of the Special Adviser to the Rapporteur, some members appeared to assume that lump-sum payments were always in the nature of a reimbursement of development expenses, which was not necessarily true, considering the various functions of such payment, which had previously been explained; and the distinction between current expenses and capital expenses was not as clear-cut as some members assumed. He, therefore, did not think that the amendment proposed would solve the problem. The members agreed that the tax treatment of lump-sum payments in the source country had considerable bearing on the issue.

118. The member from the developing country who had suggested the amendment was of the opinion that there should not be a deduction for both lump-sum payments and current royalty payments. If the source country allowed the deduction of the lump-sum payment, there simply was nothing else left for it to allow as a deduction except current expenses originating in the source country. The member pointed out that lump-sum payments described as reimbursement of the licensor’s development expenses were of comparatively recent origin and very often were used as a means to gain illegal tax advantages. Since royalty income arose both in the home country and in the source country, the question was not whether the home country taxed the lump-sum payment, but the way in which to allocate expenses to the portion of income originating in the source country. Permitting the deduction, in the source country, of lump-sum payments that had already been deducted in the home country as cost or expenses would clearly confer a double tax benefit on the licensor.

119. A member from a developed country reminded the Ad Hoc Group that it had previously favoured the view that some account should be taken of the research and development expenses incurred in the licensor’s home country.

120. With respect to the question of tax evasion, a member from a developed country pointed out that that problem could be avoided if the country of source requested a certificate, issued by the licensor’s home country, which would support the retention of tax in the source country. Such a certificate customarily stated that the claimant was a resident of the country issuing the certificate and paid tax there on the income, thus qualifying for the reduction of tax under the treaty. The member was of the opinion that if that precaution were
taken, there would be no valid objection to the sharing of revenue. With reference to the question of percentage reduction for expenses, discussed on pages 5 and 6 of the paper (ST/SG/AC.8/III/CRP.9), the member reiterated his proposal to apply either a withholding tax at the rate of 5 per cent computed on gross income or a tax at a higher rate computed on net income, such tax not to exceed 50 per cent of the tax of the home country. The member proposed to submit an alternative draft to article 12 of the OECD Model Convention in support of the views he had just expressed. The Special Adviser to the Rapporteur suggested referring to that draft by way of a foot-note at the end of the first line of the last paragraph under item 6 on page 7 of the paper under discussion. Some members from developing countries objected to that proposal because, in their view, it gave excessive consideration to expenses.

121. A member from a developing country complained that the paper under discussion did not reflect all opinions expressed during the meetings, as members had been led to believe. The member insisted, in particular, on an addition to item 4, dealing with the tax treatment of royalties between related enterprises. He also complained about the non-consideration of statements previously made by him with reference to the distinction between capital items and income items. With reference to the first point, the Special Adviser replied that, according to his understanding, item 2 of the paper would be amended by stating clearly that the treatment of royalties between related enterprises would be given due consideration.

122. A member from a developing country emphasized that the source countries were rightfully concerned about abuses in connexion with royalties. In his experience, there was continued collusion between licensors and licensees with respect to that item. He also questioned whether a licensor who had done nothing to promote the sales of his product in the source country should be given a share of the profits, especially if all expenses had already been written off in the home country. In addition to the tax problems, the member pointed out the very serious foreign exchange problems faced by developing countries in the matter of royalty payments. The Special Adviser to the Rapporteur observed that the views of the member were given consideration on pages 6 and 7 of the paper.

123. A member from a developing country pointed out that he, as well as some other members, had emphasized, from the time of the first meeting in 1968, that royalties should be taxed only at the source. Considering the discrepancy of views on that matter, the member refused to accept even a carefully qualified compromise solution. The member expressed regret at the initial acceptance of the OECD Model Convention as the basis of the discussion, which, in his opinion, currently operated to the detriment of the developing countries.

124. The Special Adviser observed that nowhere in the paper under discussion was there a statement of general agreement on the subject of the sharing of royalties.

125. With reference to the concern expressed by several members concerning the foreign exchange problems of the developing countries in connexion with the payment of royalties, a member from a developed country remarked that that aspect, while certainly requiring the most careful consideration, was not properly within the mandate of the Ad Hoc Group, which had been convened to discuss tax treaties. With respect to the issue under discussion, the industrialized countries were of the opinion that they were entitled to some of the revenue in consideration of the burdens and risks inherent in the development of patents which they had taken upon themselves.  

C. Summary of discussion on industrial royalties

126. The discussion on the treatment of royalties developed the following topics: (a) the scope of royalties; (b) the method of taxation in the source country, that of the user or licensee of the property giving rise to the royalty; (c) the interrelationship between taxation by the source country and taxation by the country of the recipient.

127. As to the scope of royalties, it was thought that the topic was divided into a number of different fields which required separate treatment. Speaking generally, the fields to be so considered involved industrial royalties arising out of patents and know-how, copyright royalties, film rentals; rentals of certain equipment, such as computers, and current technical assistance. The discussion centred at first on industrial royalties, and the remarks given below were addressed to that field. It was recognized, however, that the subject of royalty payments between related entities and all the other matters mentioned above should be considered separately.

128. The principal questions involved in taxation by the source country were considered to be those concerning:

(a) The recognition to be given to expenses associated with the royalties, usually stated in terms of whether the subject of taxation was the gross royalty or the net royalty after taking expenses into account. That aspect involved the nature and extent of the expenses to be considered and the proper allocation of expenses to gross royalties, leaving for the moment the method of actual taxation of the royalties;

(b) The method of actual taxation of the royalty payments, assuming a recognition of expenses. That aspect involved the use of the withholding tax method and the determination of a rate of tax on gross royalties that reflected the recognition of expenses.

RECOGNITION OF EXPENSES AND EXTENT TO WHICH EXPENSES WOULD BE CONSIDERED

129. With respect to whether and to what extent recognition was to be given to expenses associated with the royalties, and leaving aside the actual method by which royalty payments would be taxed, there was general agreement that the taxable income to be taxed...
was the net royalty. That was not a matter of "sharing" revenue, a subject that would be discussed under item 6 of the paper (ST/SG/AC.8/III/CRP.9), but rather a determination of the taxable base to be used in the source country. In other words, the jurisdiction of the source country being assumed, the question was that of the taxable income in the case of royalties for the purposes of an income tax.

130. Those members holding the view that the taxable base was net income might, perhaps, reach that result by various routes. Some would stress that, as a matter of legal structure, that was the proper result as the taxable income was net income after allocable expenses. Others would say that where the expenses arose outside the source country or involved different years, while there was no legal compulsion to their recognition, it was in equity or fairness, appropriate and even desirable to take the expenses into account.

131. The interests of both the licensor and the residence country, as well as the source country, were involved in the matter of net income. Thus, in the perhaps unusual case where all the receipts of a patent came from the source country, there was no other income against which to offset expenses. Where receipts came from both the residence country and the source country, and a credit system was used in the residence country, both the licensee and the residence country would be concerned under that credit approach with a determination of the proper net income arising in the source country. That situation would also be true for an exemption system in the residence country, since it would allow deduction against income from the residence country only of expenses allocable to that income, and not expenses allocable to income abroad.

132. That being so, the matter then moved to the question which expenses were to be so considered. There presumably was no problem in recognizing the appropriateness of allowing the current expenses allocable to the particular royalty. In addition, there was general agreement that expenditures in the development of the patent or other such asset should also at least be considered to see if they should be taken into account. In that connexion, some members appeared inclined to the view that any such expenditures already recouped through sales or other activities in the home country or elsewhere should not be considered allocable to the determination of the net royalty in the source country. That position rested in part on the view that such recoupment of expenditure through activities in the home country or elsewhere left the patent or other asset available to earn receipts in the source country, which receipts involved no possibility of loss to the licensor in view of the previous recoupment. It also rested on the view that while, perhaps logically, the expenditures should be taken into account, the drain on foreign exchange of the source country, where it was a developing country, involved in royalty payments should cause a developed country to forgo stress on the element of expenses. Some might go further back and apply that view to expenditures "written off" for tax purposes in the home country, even though not recouped. But the latter view, at the very least, would not appear to recognize that such a rapid write-off, made in the residence country to encourage research or because it was difficult to forecast revenues from research, should not prejudice the case of the residence country, compared with a situation in which the write-off was spread more evenly over future revenues. The rapid write-off in that respect achieved a deferral of the tax of the residence country and should not thereby militate against allowance of the expenditures in other jurisdictions.

133. Most of the members, however, took the view that it was appropriate to regard the expenditures in both of the suggestions—either recouped or just written off—as allocable against all the receipts, at home or abroad, derived from patents or assets arising from the expenditures. Hence, in that view, initial recoupment at home did not, per se, mean no recognition of the expenses in determining the net income from the subsequent utilization in the source country. That view was especially underlined by those members who stressed that many of modern research expenditures were not separated into categories, projects or objectives, so that when successful patents were developed, their particular expenditures could not be isolated and, indeed, were rather to be considered to represent the fruits of all the expenditures, including those which had, in a sense, led to unproductive results.

134. However, those members taking the view that even recouped expenditures were to be considered in finding the net royalty in a source country in turn shared the complementary view that the allocation was to be against all receipts related to the patent or other assets. Just as recouped expenditures in the home country were eligible for allocation against royalties in the first foreign country in which a patent was subsequently used, so, in turn, would they still be allocable in a second source country in which the patent might thereafter be used. In a sense, each use of the patent—past, current or future—would dilute the allocation.

135. In that respect, statements as to older patents requiring fewer expenses to be allocated were but a reflection of that situation, in that such patents tended to involve a larger sum of already experienced receipts over which the expenditures were to be allocated, thus requiring a considerably smaller allocable figure to the portion to be borne by future receipts.

136. Therefore, the difficulties of allocation became readily apparent. On the one hand, there were difficulties in bringing into a total the expenditures to be allocated; and, on the other hand, there were difficulties in bringing into a total the receipts against which allocation was to be made. While studies would be useful and should be made where possible, the lack of such studies and the obstacles in pursuing them, emphasized the elements of practical experience and pragmatic judgement that would have to be made to achieve such allocation, given the current extent of knowledge and data.

137. It was mentioned that lump-sum payments made by the licensee in the source country with respect to development expenditures of the licensor produced situations that required special consideration. Thus, as an example,
if the lump-sum payment was not taxed by the source country, the expenditures reflected by the lump-sum payment presumably would not enter into the determination of the allocable expenses.

**METHOD OF ACTUAL TAXATION OF ROYALTY PAYMENTS:**

**WITHOLDING TAX ON GROSS ROYALTY**

138. With respect to the actual method by which to tax royalty payments at the source, the uncertainties thus inherent in the task of allocation of expenses led the members to recognize the advantages in a source country of using the method of applying a withholding tax to the gross royalty. That approach had the advantage of certainty in result and simplicity of administration, as compared with case-by-case judgements seeking a more precise net figure in each case. Such certainty, it was observed, would make it less likely that the licensor would seek to shift the burden of the source country tax to the licensee, which shifting would be prejudicial to the interests of the source country. Under such a withholding-tax approach, the important factor was obviously the rate of tax. The matter could be viewed as involving at that point only the task of achieving a rate of gross royalty that approximated the over-all revenue results that would be reached through application of the regular rate of tax to the net royalty. The withholding rate thus would become the figure resulting from the estimate of the average reduction on account of expenses that would be made in gross royalties as a class to produce net taxable income, and the consequent mathematical rate relationship that would emerge. Thus, if the average reduction for expenses was \( \frac{X}{100} \) per cent of the gross royalties and the regular rate was \( \frac{Y}{100} \) per cent, the withholding rate applied to the gross royalty would be \( \left(100 - \frac{X}{100}\right) \times \frac{Y}{100} \) per cent.

139. The members were not inclined to fix a percentage figure to be used to replace the \( X \) per cent. That figure must be supplied at first by the source country in shaping its tax system, and withholding rates on gross income varied from country to country. In any bilateral negotiation, the precise figure to be used would be a subject of the negotiation where the parties so desired. Some countries, perhaps, would use a different percentage, and, consequently, a different withholding rate, for various categories of those industrial royalties; and, indeed, that eventually would become one of determination of the separate fields into which the general subject of royalties was to be divided.

140. As a technical matter, it was observed that if the country of residence used a credit method, the expense ratio underlying the establishment of the withholding tax on the gross royalty should also appropriately be used by the residence country, whenever feasible, in determining the figure of net income from the source country to be applied in calculating the limitation on such credit.

**ASPECT OF “SHARING” OF TAX ON ROYALTY PAYMENTS**

141. The remarks about the method of taxation on the source country and the general desirability of using a withholding rate on the gross royalty payments, the rate being determined by a judgement on the appropriate over-all relationship of expenses to gross royalty, led to the matter of the relationship of such taxation at the source to taxation in the country of the recipient. Presumably, in the absence of a treaty, each country would assert its concept of tax jurisdiction. The country of residence, unless it followed an exemption approach to foreign income, would tax the recipient under its regular tax. The country of residence would then apply the unilateral method, if any, it followed in reducing double taxation.

142. A bilateral treaty discussion would thus take the matter as it appeared at that stage. The parties would have to consider whether they desired a change in the relationship of the two existing tax results, one at source and one at residence. Thus, as one example, if the relationship between the two effective rates of tax (the tax at net on regular rates in the residence country and the withholding tax at gross in the source country, with the latter rate usually set to reflect the amount of expense) were such as to place the source country tax at a higher level than the residence country tax, and hence above any allowable credit, the negotiation would consider the appropriateness of a reduction in the source country rate. As another example, if the relationship were such that the source country tax was in the same range as the residence country tax, so that the source country tax entirely or almost entirely absorbed any residence country credit, the residence country might, in pursuit of a "sharing" of the revenue from the royalty, seek a reduction in the source country tax for that purpose. If the situation did not involve a unilateral credit by the residence country, but the fixing of the amount of credit in the treaty, there also, the relationship of the amount of such credit to the source country tax would involve the aspect of "sharing" revenue.

143. In that connexion, the expressions of points of view on the part of members from developed countries indicated various degrees of emphasis on pursuing such a sharing, with some perhaps more inclined than others to seek a lowering of the source country rate for that purpose and more inclined to widen the margin of difference between the two rates. In turn, the points of view of members from the developing countries indicated various degrees of emphasis on the wisdom and desirability of such a reduction, with expressions of preference for the approach of no "sharing" (often expressed in terms of "exclusive jurisdiction" in the source country) or, at best, only a minor sharing, and some perhaps more inclined to move further in the direction of such a reduction. Similarly, where the particular treaty concerned the amount of any credit to be allowed by the residence country, those varying views would be reflected in the judgements as to the amount of the credit and the consequent relationship to the source country rate.

144. The various attitudes reflected the varying degrees of emphasis placed by the countries on the many factors involved. Among the factors enumerated, some pointing one way and others a different way, were: the need for
revenue and conservation of foreign exchange by the developing countries; the fact that royalty payments flowed almost entirely from developing countries to developed countries; the extent of assistance that developed countries should, for a variety of reasons, extend to developing countries, and the special importance of providing such assistance in the context of royalty payments; the desirability of preventing a shifting in the licence arrangement of the tax burden to the licences; the ability that taxation at source provided to a developing country to make selective judgements by which, through reduced taxation or exemption, it could encourage those licence arrangements it considered desirable for its development; the lessening of the risks of tax evasion if there was, in fact, at least taxation at the source; the fact that the country of the licensor supplied the facilities and activities necessary in the development of the patent and thus undertook the risks associated with the patent; the desirability of obtaining, and encouraging, a flow of technology among countries and to developing countries; the desirability of enlarging the field of activity of the licensor in the utilization of his research; the benefits that developed countries would obtain from world development in general; the relative importance of revenue sacrifice; the relationship of the royalty decision to other decisions in the negotiations.

145. All those factors being so, there was again a general disinclination, not shared by all,\(^\text{21}\) not to specify a particular percentage figure as the appropriate figure, or target figure, for the source country tax. That matter was considered to be an important aspect of the negotiation itself. Moreover, it being less likely that members would, a priori, agree on a generally applicable rate than on the factors and attitudes that were relevant in leading to the final judgements on that rate, more useful progress could be made in describing those relevant aspects of the problem. The foregoing discussion reflected the views on those aspects.

146. In the light of the summary of discussion on industrial royalties, the Ad Hoc Group reached general agreement on guidelines for the determination of the rules for the taxation of industrial royalties in general, apart from payments between related articles. Those guidelines expressed the over-all aspects of the discussion, and the elaborations and more detailed aspects were reflected in that discussion:

(a) In the absence of a treaty, both the country of source and the country of the recipient of the royalty might tax the royalty, subject to whatever unilateral double-taxation relief might be granted by the country of the recipient;

(b) The country of source, in establishing a withholding tax on the gross royalty in a tax treaty, would, from the standpoint of the effect of expenses allocable to the royalty payments, recognize that both current expenses allocable to the royalty and expenditures incurred in the development of the property whose use gave rise to the royalty were to be considered, taking into account in such consideration that the latter expenditures were also allocable to profits derived from other royalties or activities, past or future, associated with those expenditures, and also that other expenditure not directly incurred in the development of that property might, nevertheless, have contributed significantly to that development;

(c) In bilateral negotiations, there normally would be consideration of those two claims to taxation, and the negotiations might accommodate those claims to the extent agreed upon;

(d) As a technical matter, if an expense ratio were agreed upon in fixing a gross rate in the source country, it would appear as a consequence that the country of the recipient, if following a credit method, would apply that expense ratio as the basis for determining the application of its credit, whenever feasible. Therefore, that matter should be considered under article 23.

\(^{21}\) A member from a developed county, holding the view that a specified percentage figure was desirable had introduced a specific approach in the paper (ST/SG/AC.8/III/CRP.9 and Rev.1).
III. EXCHANGE OF INFORMATION AND INTERNATIONAL TAX EVASION AND AVOIDANCE

A. General discussion

147. At the second meeting of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD) had submitted a request to consider the issue of tax evasion and avoidance, with special reference to potential, as well as actual, income information exchanges under current bilateral treaties and domestic law. The Ad Hoc Group had also been asked to consider measures, apart from bilateral treaties, that could be used to discourage capital outflow from developing countries. The Ad Hoc Group had discussed that issue and had agreed that it needed further intensive study. In that connexion, the Secretariat had prepared a questionnaire on international tax evasion and avoidance (ST/SG/AC.8/R.12). More than 40 replies had been received from Governments.

148. As a result of those conclusions, the Secretariat, with the assistance of consultants, had prepared a series of cross-sectional studies dealing with the following problems: simple methods of international income-tax evasion; international tax havens (ST/SG/AC.8/R.20/Add.1); information gathering and exchange for income-tax purposes (ST/SG/AC.8/R.20/Add.2). In addition, extensive country case studies had been made on fiscal fraud and international co-operation in France in relations with the French-speaking countries of Africa and on tax avoidance and tax evasion in India. A similar study was to be submitted shortly on international tax evasion and avoidance in Mexico.

149. The Special Adviser to the Rapporteur explained that the problem of tax havens should be considered under two different aspects, namely, the situation of a country being used against its will as a tax haven and that of a country desiring that status. The methods used by taxpayers who wished to exploit tax haven facilities would obviously differ in the two situations named, as would the countermeasures of the Governments affected.

150. The Ad Hoc Group first discussed tax evasion, i.e., transactions that were clearly illegal under the law of the country where such offences were committed.

151. A member from a developing country pointed out that the annual loss of tax revenue and, in particular, foreign exchange suffered by his country was of major proportions even in relation to the foreign aid that the country received. Combating tax evasion was difficult for his administration to accomplish because it practically always involved collusion between a business enterprise in his country and one in another country, usually a developed country. For that reason, co-operation in that area by the developed countries would be extremely helpful. The member described some of the methods used to avoid payment of tax and to bypass foreign exchange restrictions, such as the overpricing of imports into his country and the underpricing of exports from there. Although his country had co-ordinated tax enforcement by setting up a central investigative unit to which various government agencies, including the tax department, the customs administration and the exchange control authorities, directed information, co-operation by other Governments was very urgently needed. The member was of the opinion that an automatic exchange of information between Governments would not be advisable because of the resulting communication of a mass of irrelevant data which might also be used on occasion by some minor official to begin an investigation of his own. Information should therefore be supplied only upon request, both to limit investigations to important cases and to instil confidence in the other Government.

152. A member from another developing country considered that the documents prepared by the Secretariat gave an important description of the subject-matter and might be amalgamated in a single document which then could be distributed to all States Members of the United Nations. The principal difficulty, in the member's view, was that not all countries produced the same kind of fiscal information or had statutory authority to obtain it. In order to remedy that situation, it would be helpful if all countries were made aware of the urgent necessity to introduce pertinent legislation and to exchange information with other Governments. He also expressed himself in favour of specific requests for information, as distinguished from the routine communication of fiscal data.

153. Another member from a developing country reminded the meeting that the first topic considered by UNCTAD had been the outflow of capital from developing countries. Most illegal transfers of capital resulted from overstating or understanding invoices for export and import transactions. Such violations were always
the result of collusion between a business enterprise in the developing country and one in the developed country. Practical experience had shown that otherwise reputable organizations in developed countries continuously indulged in such violations, which had caused his country millions of dollars per annum in lost tax revenue and foreign exchange. There was no reason why tax administrators in developed countries should not be able to look into transactions where some percentage of invoice prices was held back.

154. The Special Adviser to the Rapporteur explained that there were obstacles to the discovery of fraud in the developed countries, considering that the illegal advantages referred to were often camouflaged as rebates. In addition, the illegal payments might be made to a bank account in a tax haven country outside the jurisdiction of the developed country. There was also the problem that tax examiners of the developed country might have to go beyond their normal functions to detect such violations.

155. A member from a developing country asserted that officials of the developed country should at least make an effort to detect and analyse the illegal transactions discussed. Considering the prevalence of such transactions and the amounts involved, their suspicions should be aroused if millions of dollars in commissions were rebated and transferred to the developing country or elsewhere.

156. Another member from a developing country remarked that the undisclosed commissions might be taxable in the developed country and that it would not take much effort or cost to detect them. The member asserted that only important items should be made the subject of such an investigation and disclosure to the other country.

157. A member from a developing country also stated that in some cases tax fraud occurred in the matter of exports by means of under-invoicing.

158. A member from a developing country observed that international tax evasion could be combated only by exchanges of information between Governments. One of the difficulties was that a developing country that lost tax revenue or foreign exchange through the manipulations discussed had to raise its taxes or to accept more foreign aid; increased taxation, in turn, would lead to increased tax evasion. The member expressed himself in favour of setting up an organization, similar to the International Criminal Police Organization (INTERPOL), to combat international tax evasion. He thought that fiscal information should not be supplied only upon specific request of a Government. Unless the Government had ground for suspicion, it would not be in a position to make a specific request.

159. The member then described certain instances of fiscal fraud. An alert tax examiner should be aware of the fact that illegal payments have often been made to persons who were not parties to the transaction under review and that no deduction was normally available for such payments under the law of any country. Another member remarked that concealed money was very often used for highly illegal purposes so that all Governments had a common interest in co-operating in that area.

160. A member from a developed country explained that while the problems were similar in his country, there were at least two important differences. One difference was that tax-payers intent on defrauding the Government did not as a rule, use crude methods that were, easily detected. They usually applied methods that had a semblance of legality so that they could assert ignorance or good faith when they were found out. In addition, the remedies available to the Government were somewhat limited. Speaking of commissions, the Government of his country had authority to disallow the deduction if the recipient of the payment was not disclosed or if no services rendered by him could be substantiated. Furthermore, payments to a party abroad could be made subject to withholding of tax at the source. It appeared to the member that the Government had fully met its responsibilities by applying those methods and that disclosing information to other countries might raise legitimate objections. One difficulty was that no further proceedings could be brought against the taxpayer who accepted a disallowance or paid the withholding tax. Another obstacle was that payments were practically always made to nominees or to some bank account or intermediate enterprise. The member stated that his Government had no authority to disclose information obtained about an enterprise in one foreign country to the Government of another foreign country. Moreover, special consideration should be given to the fact that differing legal practices in the matter of disclosing tax information might give rise to serious disadvantages for firms in the countries concerned in respect of their competitive positions towards enterprises in the countries taking a more lenient position. This consideration applied also to Governments who had no tax treaties. The problem obviously required co-operation by all Governments to ensure equal application of the information desired.

161. A member from a developing country suggested that publicity given in newspapers and other publications about importers on import transactions, licences issued, standard prices for certain imports and similar data might be helpful. Governments might also ask international organizations, such as UNCTAD, to publish such information; and countries with exchange control restrictions should utilize that weapon for better control. Another member remarked that too much attention had been given in the current discussion to shipments going from developing countries to developed countries. The same situation prevailed in the opposite kind of transactions.

162. A member from a developing country pointed to the difficulties and additional burden that any country faced in connexion with requests for assistance by other Governments. Most fiscal administrations suffered from lack of funds and qualified personnel and were scarcely able to cope with their regular duties. As welcome as intensive co-operation by other Governments would be, it would be highly unrealistic for any administration to expect foreign administrators to do its own work. The
member stated that Governments had considerable difficulties in combating tax evasion at home and that only a fraction of taxpayers could be examined to begin with.

163. The member suggested that a lowering of tax rates, rather than an increase thereof, might be indicated to reduce the incentive for tax fraud. Requests for information directed to a foreign Government should be limited to what the foreign administration was able to cope with and should therefore be restricted to specific situations. On the other hand, the member suggested that the tax administration of a country could reasonably be expected to pass on information that its investigations had disclosed to another country which was equally interested in the information. The member from a developing country said that the developing countries should have more interest in proceeding through international tenders in order to reduce the risks of manipulation of prices for the purpose of tax avoidance.

164. A member from a developed country questioned that the comprehensive exchange of information proposed by some members was feasible. Under the law of the member's home country, the tax authorities were required to obtain information from the taxpayer. Similarly, a country should be required to exhaust its own sources of information first before requesting information from the authorities of another country. At least under the law of the member's home country, the tax administration would not be authorized to give to a foreign Government more information than it was permitted to obtain in domestic cases. Those problems could not be solved simply by inserting a clause in a tax treaty. Exchange of fiscal information, as such, was not the solution to the all-pervading problem of tax evasion. Apart from the limitations described, the member stated that his Government would not be willing to co-operate with a foreign Government concerning an exchange of information outside the field of taxation.

165. A member from a developing country suggested that considering the short time available, the substance of the general discussion held to that point might be made available to other countries requesting it. Specific matters might then be discussed fully at the next meeting of the Ad Hoc Group.

166. After some discussion concerning the proposed scope of the analysis to be prepared by the Secretariat, the Special Adviser to the Rapporteur observed that members agreed on the desirability of a country making specific information obtained in a pending tax evasion case available to another country interested in the matter within the legal and administrative limits of such assistance. Without taking any position at this time, members might authorize the Secretariat to proceed with such a study on the basis of the various proposals in that direction made by members of the Ad Hoc Group. Upon the request of the member from a developed country, the Special Adviser agreed to summarize the proposed terms of the study in writing.

167. A member from a developed country expressed his agreement with the procedure proposed, but pointed out that the authors of the proposed study should also consider the rules that the various tax administrations must observe to obtain information. Investigation of bank transactions would be an example in point. The member proposed that an inventory of legal and administrative measures available to the various tax administrations might be prepared. A member from another developed country supported that statement and emphasized again that a country could not request more far-reaching information from another country than it would be authorized to request from its own nationals in domestic tax examinations.

168. The Special Adviser pointed out that he did not want to be understood as suggesting that specific recommendations should be made by the Ad Hoc Group at that time. The question was solely what problems the Ad Hoc Group considered should be the subject-matter of the study by the Secretariat. With reference to the common methods of tax evasion discussed, the study should, in his opinion, determine what tools tax administrators would have at their disposal to combat such manipulations, assuming that other countries would co-operate. The Ad Hoc Group agreed on the desirability of a study on that subject, the outline of which is described below.

B. Proposed study on exchanges of information

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 believed to be of assistance to another tax administration where an investigation or other matter carried on in the first country independently developed the information;

(c) The aspect of automatic furnishing of information considered 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 with respect to 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 would be permitted to use the information furnished; and any other relevant matters.
C. Tax-incentive legislation in developing countries and the relationship of those incentives to the tax systems and development assistance programmes of capital-exporting countries

171. In the course of informal consultations between members, a paper (ST/SG/AC.8/III/CRP.10/Rev.2) was introduced with respect to the interrelationship between the incentive programmes of developing countries and the double-taxation relief provisions of developed countries. In the paper, attention was called to the fact that obstacles to treaties between developed and developing countries had arisen where the solutions worked out between some countries with respect to that interrelationship, such as the so-called "tax-sparing credit", were not utilized by other developed countries. Consequently, in the paper, a study was proposed that would examine alternative methods of dealing with that interrelationship in the effort to remove such obstacles. The Ad Hoc Group did not have sufficient time to consider that subject in detail. Therefore, it concluded that a study should be made. That matter and the study itself are described below.

172. Many developing countries had adopted tax-incentive legislation in connection with programmes to promote local investment and to attract investment from capital-exporting countries. The interrelationship of that tax-incentive legislation with the tax laws of the capital-exporting countries had become an important aspect of treaty negotiations between developed and developing countries. That interrelationship depended in large part upon the nature and technical aspects of the systems of relief against double taxation provided by a particular capital-exporting country for its investors who invested abroad.

173. Considerable discussion on that matter had taken place in the previous 15 years. In a number of instances, the accommodation desired by administrations of tax-developing countries to meet problems they perceived in the above-mentioned interrelationship had been the grant by capital-exporting countries of so-called "tax-sparing" credits. Those credits, in effect, reduced the residence country income tax on the investor to reflect, in varying extent, the reduction in the developing country income tax brought about under tax incentives provided by the latter country. That approach had been adopted in a number of tax treaties. In other situations, however, treaties had not been concluded where that approach had not been considered desirable by the developed country and a suitable alternative approach or other solution had not been found.

174. The United Nations Secretariat had prepared a series of monographs on the interrelationship between the tax systems of certain capital-exporting countries and those of developing countries, with particular reference to the aspect of tax incentives.27 A paper was also submitted on the general double-taxation relief provisions of capital-exporting countries; the addendum to that paper dealt mainly with a description of existing tax treaty provisions embodying "tax sparing".28

175. Informal discussions of the matter by the Ad Hoc Group developed the view that it was important to continue the study of the subject to develop a range of solutions regarded as appropriate by the various countries involved. Such a study might help to resolve obstacles which currently, in some circumstances, restricted the entering into of tax treaties between developed and developing countries. There was not sufficient time for the Ad Hoc Group to explore the matter, but it did decide that a study should be made.

176. Some phases of a broad study would include:

(a) An analysis of the application of "tax-sparing" provisions and the experience obtained through their use, e.g., their technical characteristics, their effectiveness in attracting investors of capital-exporting countries, the financial sacrifices involved on the part of both the developing and the developed countries utilizing that approach, their effect on reinvestment or repatriation of profits, whether problems of tax avoidance or evasion had arisen, whether administrative problems had arisen etc.;

(b) An analysis of the effectiveness of tax-incentive programmes in the absence of "tax-sparing" provisions, to ascertain in a comparative way the differences in investment quantity, patterns, reinvestment, repatriation and the like between that situation and the one considered in (a);

(c) An analysis of alternative methods, other than "tax sparing", of approaching tax treaty negotiations involving the relationship of a developed country to a tax-incentive programme used by a developing country. Among alternative methods to be explored would be a system of direct investment assistance allowances outside the tax system of the capital-exporting country, but integrated with its tax treaty programme.29 That analysis would cover the structure and mechanics of such a system, its compatibility with other governmental policies and the organization of the various governmental agencies that would become involved in the developed country; its probable effects in comparison with "tax sparing" with respect to such matters as comparison in assistance offered, effect of eliminating dependence of investment assistance on the continued maintenance of a tax-incentive programme by the developing country (as needed in the case of "tax sparing"), effect of offering investment assistance even though no tax-incentive programme was maintained by the developing country (unlike "tax sparing"); administrative and other relevant matters. Thus, the analysis would indicate the advantages and disadvantages of such an alternative approach with respect to both developed and developing countries.

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27 "Taxation of private investment in developing countries by the Federal Republic of Germany" (ST/SG/AC.8/R.31); Interaction between the French Tax System and Those of Developing Countries (United Nations publication, Sales No. E.71.XVI.3); "United Kingdom tax treatment of private investment in developing countries" (ST/SG/AC.8/R.22); United States Income Taxation on Private Investment in Developing Countries (United Nations publication, Sales No. E.70.XVI.2).

28 See part two, chap. VII, of the present report.

29 One of the methods suggested by some members as an approach to be explored in the context of such a study is set forth below.
including developing countries with major tax-incentive programmes and those with less extensive or no programmes, but utilizing other measures, such as direct grants;

(d) An analysis, to the extent feasible, 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). Such a study, in addition possibly to providing insights on the general utility of tax measures to attract investment, would, by evaluating particular types of incentives, focus attention on those possessing importance for international tax relationships and negotiations. Such a study might also consider a comparison between the use of tax incentives and the use of direct grants by a developing country.

ALTERNATIVE METHOD PROPOSED FOR STUDY

177. A tax treaty with a developing country might provide for an “investment assistance allowance” to be made by the residence country to assist investments by its residents in the developing country.

178. Such a treaty should specify the types of investments eligible for such assistance, the duration of the assistance and any other relevant conditions. Those factors might be developed, to the extent appropriate, by reference to aspects and requirements of the investment laws, tax laws and other laws or policies of the developing treaty country.

179. The “investment assistance allowances” should be paid by the appropriate government agency in the residence country (here called “agency”) concerned with the encouragement of investment in developing countries.

180. The allowance should automatically be paid by the agency to an enterprise of the residence country certified by the treasury of that country as eligible for the allowance. Such certification should state:

(a) The enterprise had invested in the developing treaty country, either directly or through a subsidiary, describing the nature of the investment;

(b) The amount of any capital investment made in the year, and the amount of any reinvested earnings in the year;

(c) The amount of profits received by the enterprise, as dividends or branch profits, in the year from the investment.

181. Investment assistance allowance might be in several forms:

(a) A capital investment allowance equal to $x$ per cent of any capital investment made by the enterprise in the year;

(b) A reinvested earnings allowance equal to $y$ per cent of any reinvestment of earnings in the year;

(c) An earnings increment allowance equal to $z$ per cent of any dividends or branch earnings received by the enterprise in the year.

182. The treaty should specify the requisite percentage and which type of allowance or combination of allowances should be made in the case of the treaty country. The eligibility certificate should, in turn, state the type of allowance or allowances for which the enterprise would be eligible.

183. The manner of payment of such allowances and the requisite appropriation should be structured to take account of the automatic character of the allowances.
IV. FUTURE WORK PROGRAMME

A. Report of the working group

184. The Ad Hoc Group then proceeded to discuss the recommendation for implementation of the objectives of the group and the future work programme (ST/SG/AC.8/III/CRP.11 and Rev.2).

185. A member from a developing country introduced the paper on behalf of a group of members. He expressed his satisfaction with the accomplishments of the Ad Hoc Group, which would be of real assistance to developing countries. He stated that it was time to consider the future work of the Ad Hoc Group, which clearly was not in a position to complete its current agenda at the meeting. Two principal questions remained to be considered at the current meeting, concerning the procedures and functions of the Ad Hoc Group. For one thing, the continuity of its work should be assured. Secondly, future meetings should be held more frequently than every 18 months as in the past.

186. In the paper, it was proposed that the Economic and Social Council of the United Nations be requested to give continuing status to the Ad Hoc Group until its work was completed. The proposal was accepted.

187. There was general agreement that much had been accomplished by way of discussion and guidelines and that it would be most regrettable if the work of the Ad Hoc Group were discontinued before its assignment was completed. Several members from developing countries stated that the work of the Ad Hoc Group had already been of fundamental importance to countries without experience in negotiating and concluding tax treaties. Members from both developed and developing countries pointed out that the two published reports had been used to advantage in their treaty negotiations with countries of the opposite group. Mention was also made of the fact that the work of the Ad Hoc Group was being observed with the greatest interest by developing countries that were not represented at the meeting and that it would be most desirable from the standpoint of those countries if the Ad Hoc Group completed its assignment.

188. There was no difference of opinion on the question that the Ad Hoc Group should be permitted to complete its current assignment. One member from a developing country suggested that the work should be continued beyond that stage and be extended to tax problems not directly connected with the conclusion of tax treaties, such as technical assistance and support in administrative problems.

189. One member from a developing country stated that notwithstanding the high quality of the work performed by the Ad Hoc Group, it would be necessary to clarify its mandate and to set up precise procedural rules. Provision should be made for plenary sessions, for working groups and for decisions to be taken by vote. Procedural improvements of that kind would be helpful in removing certain deficiencies that had become apparent in the current meeting.

190. There was unanimous agreement in favour of holding from three to four meetings as soon as possible. Several members pointed out that careful attention should be given to the remaining work programme. There were very important topics not yet discussed, such as non-discrimination and exchange of information among Governments, including competent authority procedures.

191. A member from a developed country stated that publication of reports of the past work of the Ad Hoc Group had had an international impact of major proportions. It would be advisable, however, for its procedures to be improved to some extent. Future meetings should be scheduled in ample time beforehand. Supporting documentation should reach the members as soon as possible. It might also be practical and provide relief to the Secretariat if a special rapporteur were to be appointed for each topic. Lastly, it might be considered to attempt to have a concise report by topic. The member declared himself in favour of describing the future work of the Ad Hoc Group in somewhat general terms so that its proceedings would not be hampered by narrow restrictions.

192. In reply to a question put by a member from a developed country, the Secretary of the Ad Hoc Group described the work that had been done by the Secretariat during the past year in connexion with tax-reform planning and the solicitation of replies from a number of Governments to a questionnaire dealing with tax avoidance and evasion.

193. All members agreed that the “ad hoc” description of the group should be discontinued and that it should become a continuing body. One member from a developing country favoured the term “pioneering group” because of the nature of its work, which no other body of experts had previously undertaken.

194. The Ad Hoc Group then expressed its unanimous appreciation of the extensive and valuable technical documentation prepared by the Secretariat, which had served as the basis of its consideration. The Ad Hoc Group also thanked the Secretariat for the diligent and efficient manner of servicing the current meeting.
B. Recommendation for implementation of the objectives for which the Ad Hoc Group of Experts was appointed and its future programme

195. At its third meeting, the Ad Hoc Group had made useful progress in connexion with the treatment of shipping profits and royalties in bilateral treaties between developed and developing countries; it had also undertaken exploratory work on other problems, in particular, the important issues related to tax sparing and alternative incentive measures and to international tax evasion and avoidance.

196. The Ad Hoc Group found it essential to obtain considerable background material and documentation for the future consideration of those and other remaining important subjects. To complete that work, further meetings must be held. The Ad Hoc Group wished, furthermore, to stress the need for a more speedy and effective consideration of those subjects. Therefore, the Ad Hoc Group recommended that it should be authorized to continue to meet as a regular group (and not an Ad Hoc group) subject to review of the work after three meetings. The outstanding major subjects included, in particular, the important questions of dividends and general double-taxation relief provisions and guidelines on issues not yet discussed, as well as other important issues, namely: (a) international income allocation; (b) methods of international tax evasion and avoidance and measures to deal with them; (c) international aspects of tax incentives and their reciprocation by tax sparing or other methods of investment assistance.

197. The work should cover the following programme:

(a) Completion of the guidelines for tax treaties between developed and developing countries:

(i) Completion of the items not finished in the meeting, in particular, dividends, the general relief provisions (including tax sparing), international income allocation and international tax evasion and avoidance;

(ii) Items that had not been discussed: non-discrimination; mutual agreement and competent authority procedure; fiscal domicile; income from immovable property.

(b) Since the conclusions reached had been drafted in a short period of time, they should be further examined to see that they were consistent as a whole and, in particular, reviewed in the light of the decisions on general relief provisions;

(c) Furthermore, there was a need to study in greater detail the implementation of the tax agreements, particularly with respect to income allocation, tax evasion and avoidance, and tax incentives (see paragraph 196), which were of great importance to developing countries.

INTERNATIONAL INCOME ALLOCATION

199. The ever-changing problems of international income attributions and allocation were, in many instances, dealt with only summarily in tax conventions. For instance, some of the more difficult questions arose in connexion with the pricing of goods and the evaluation of intangibles or services for the purpose of arriving at a fair charge. Clearly, the current structure of many tax treaties was inadequate without further guiding principles to cope with those and other intricacies of modern business.

200. In addition, the discussions of the Ad Hoc Group of Experts had revealed the importance of the determination and characterization of net income in the source country, namely, the net components of such items as shipping profits, royalties and interest, as well as suitable allocation and attribution methods.

201. Thus, it was proposed that, as between countries at varying stages of economic development, an in-depth study of modern business accounting and tax administration practices should be conducted to evaluate current income allocation and attribution methods with a view towards development of more equitable and long-lasting guidelines for use in tax treaty negotiations. The outline of such a study is given below:

Allocation

I. Problem of determination of net income in the source country

A. In general: components of shipping profits, royalties, interest etc.

B. Special problems of allocating net income between related entities: separate accounting, fractional apportionment, presumptive methods, transfer pricing, head-office expenses (including charges for interest royalties and fees), etc.

II. Allocation of tax on net income as determined above

A. Exemption at source

B. Source taxation with credit or exemption in the home country

C. Sharing

INTERNATIONAL TAX EVASION AND AVOIDANCE

202. Another important area in which inquiry and discussion were needed was that of international tax evasion and avoidance. The special request of the Secretary-General of UNCTAD to the Ad Hoc Group to deal with that matter indicated that it was of particular concern to developing countries. The primary areas of focus for the Ad Hoc Group in the areas of tax evasion and avoidance included: (a) the more common methods of international tax evasion and avoidance and their possible corrections through improved procedures and methods of exchange of information; (b) the effect of bank secrecy, bearer securities and other institutional matters on tax evasion; (c) the use of more complex methods of evasion and avoidance through utilization of tax havens and foreign-based enterprises, and the methods of correction available through domestic legislation and international agreements; (d) the abuse of tax exemptions and tax incentives and methods of correction.

30 The work on international aspects of tax incentives is described in paras. 171-183 of this report.
ANNEXES

ANNEX I

Resolution adopted by the Economic and Social Council (1541 (XLIX))

TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

The Economic and Social Council,

Recalling its resolution 1273 (XLIII) 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 (XLIII);

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 and conference room papers a

A. WORKING PAPERS

1. Taxation of Shipping Profits under the Laws of Selected Developing Countries (ST/SG/AC.8/R.18)

2. Issues relating to taxation of royalties. Paper submitted by the member from India (ST/SG/AC.8/R.7/Add.3) b
   - Taxation of royalties received by non-residents under the laws of selected developing countries b
   - The scope of royalties (ST/SG/AC.8/R.6/Add.2 and Corr.1) b

3. Tax treatment of dividends (ST/SG/AC.8/R.29)

   - Tax incentives for reinvestment (ST/SG/AC.8/R.13)
   - Interaction between the French tax system and those of developing countries (ST/ECA/149)
   - United Kingdom tax treatment of private investment in developing countries (ST/SG/AC.8/R.22)
   - Taxation of private investment in developing countries by the Federal Republic of Germany (ST/SG/AC.8/R.31)

5. Simple methods of international income-tax evasions (ST/SG/AC.8/R.20)
   - International tax havens (ST/SG/AC.8/R.20/Add.1)
   - Information gathering and exchange for income-tax purposes (ST/SG/AC.8/R.20/Add.2)
   - Fiscal fraud and international co-operation in France and in African countries of French expression (ST/SG/AC.8/R.19)
   - Tax avoidance and tax evasion in India (ST/SG/AC.8/R.21)
   - Questionnaire on international income-tax evasion or avoidance (ST/SG/AC.8/R.12) and replies thereto
   - Summary (Chap. V) and conclusions (Chap. IV) to the responses to questionnaire on international income-tax evasion or avoidance (ST/SG/AC.8/R.30 and Add.1)

6. Possibility of establishing an international panel (ST/SG/AC.3/R.14)

B. CONFERENCE ROOM PAPERS

1. Some proposals concerning a permanent international panel of tax experts and administrators. Suggestion of the member from Israel (ST/SG/AC.3/III/CRP.1)

2. Tax evasion resulting from payments made abroad. Prepared by the Inter-American Center of Tax Administrators (ST/SG/AC.8/III/CRP.2)

3. Brief survey of the documentation on international tax evasion and avoidance submitted to the third meeting of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries. Note by the Secretariat (ST/SG/AC.8/III/CRP.3)

4. Some proposals concerning royalties and shipping and aircraft profits. Suggestion of the member from the Philippines (ST/SG/AC.8/III/CRP.5 and Add.1)

5. Confidential Summary of recent work by the OECD Committee on Fiscal Affairs and taxation of shipping and air transport (ST/SG/AC.8/III/CRP.6)


7. Royalties (ST/SG/AC.8/III/CRP.8/Rev.1 and Add.1)

8. Summary of discussion on industrial royalties (ST/SG/AC.8/III/CRP.9 and Rev.1)

9. Tax-incentive legislation in developing countries and the relationship of those incentives to the tax systems and development assistance programmes of capital-exporting countries (ST/SG/AC.8/III/CRP.10/Rev.3)

10. Recommendation for implementation of the objectives for which the Ad Hoc Group of Experts was appointed and its future programme (ST/SG/AC.8/III/CRP.11 and Rev.2)

a Conference room papers were available only to participants.

b Distributed at the second meeting of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries.
ANNEX III

Alternative draft to articles of the OECD Draft Convention and suggestions of members of the Ad Hoc Group of Experts *

OBSERVATIONS ON SHIPPING PROFITS: SUBMITTED BY THE MEMBER FROM INDIA

Profits to be allocated are the profits of the relevant year. They reflect trading activity, which results from operations in the various countries of visitation. The word “profits” in this sense is different from the “taxable profits” computed by a country according to its laws. Normally, the “taxable profits” determined by the basis of the accounting result of a year would be more or less the same for all the countries as the principles of determination of taxable profits are generally alike. The substantial variations arise because some countries may allow losses of prior years (often limited) for set off; when two enterprises in the country of residence, one with a large balance of loss and another not having such losses, amalgamate, laws of some countries allow such accumulated losses for the purpose of carry-forward and set-off and some do not, while some do not. In the light of these and other wide variations in tax laws of different countries, it is necessary to understand the term “profits” to mean profits of the year calculated according to the tax laws of the country of residence, but without any set-off or deduction for losses carried over or special incentives. To such profits as are determined by the country of residence may be applied the ratio of outward freight and earnings to total freight and earnings (on account of shipping only) as displayed in the ratio certificate. This method of allocation has been suggested for the sake of administrative convenience, as, otherwise, a shipping enterprise would have its income determined separately in each of the visiting countries. If this method is considered inappropriate by any of the visiting countries, however, it may adopt such method as is agreed upon in bilateral negotiations, e.g., it may take a percentage of gross earnings as the income of the year.

Article 25 on page 87 of the OECD Draft Convention, recognizing the inherent difficulties of the situation, lays down:

“The use of any method which allocated to a part of an enterprise a proportion of the total profits of the whole, does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own law.”

ALLOCATION OF INCOME BETWEEN DIFFERENT SOURCE COUNTRIES OF A SHIPPING ORGANIZATION: A NOTE SUBMITTED BY SOME MEMBERS FROM DEVELOPING COUNTRIES

For over 50 years, many countries within the British Commonwealth have adopted the principle of apportioning income in the ratio of total outward-freight earnings in the source country upon total freight earnings of the shipping enterprise. A certificate, called a “ratio certificate”, issued by the inspector making the assessment in the home country, sets out the total earnings and the net computed income, stating the ratio of the computed income to freight earnings, as well as the ratio of the depreciation allowances (granted in the home country) to the total freight receipts. This certificate enables the tax inspector in the source country to ascertain the due proportion of that income which is to be taxed in that source country by applying these ratios of income and depreciation to the total outward-freight receipts earned in that source country. The ratio of outward-freight receipts has been found to be the most convenient method. The particular matters to be separately considered for deductions are:

(a) Interest payments, including interest paid on debentures;
(b) Allowances other than the normal depreciation allowance;
(c) Income other than income from international shipping, i.e., income from internal shipping operations in the home country, as well as income from investments.

It is not considered unreasonable to allow a deduction in respect of these items from the total income of the shipping enterprise. In the case of incentive and other capital allowances, the need to make adjustments is considered necessary by certain countries; and such variations would be a matter for consideration in negotiating bilateral agreements.

The need to distinguish a shipping enterprise from other enterprises, particularly as concerns the concept of a “permanent establishment”, and to clarify what are casual calls (i.e., non-taxable operations) was explained in full, taking into account the fact that the entire operation in international shipping is carried out in the open seas and the captain of the ship really controls the whole operation, including recovery of unpaid dues. A ship may call only once, but as a planned operation. It may not call thereafter or it may come under another charterer. Even a single call of this kind is an operation, the profits of which are taxable as profits arising at that port of call.

The second issue arises from the need to give some benefit to the home country, a need which is brought out by the consideration of the case where the ship may not take any freight from the home country and all its freight earnings may be from ports in other countries, so that no income could be allocated to the home country when the ratio of outward-freight earnings is applied to allocate income. Appreciating this problem, as well as the claims of the home country to a share in the profits of any one operation, the fact that a share in the tax levied by a source country to the credit of the home country has been recognized. This could be satisfied by reducing the rate of tax imposed by the source country so that the residue would go to the benefit of the home country. Ceylon, in all its agreements, has reduced the tax on shipping profits to one half. It should be mentioned that the allocation of profit to capital and management is contrary to the normal principles of allocating income to a permanent establishment. It is therefore considered preferable to keep the benefit to the revenue of the home country by way of a tax remission and not to recognize the allocation of any profit to management or capital.

* The appearance of material in this annex does not necessarily indicate that the material was discussed by the Ad Hoc Group. The discussions and conclusions of the Ad Hoc Group appear in the report.
ARTICLE 12: SUGGESTION OF THE MEMBER FROM SWITZERLAND

Extended discussions in the first and third session of the Ad Hoc Group of Experts have proved that neither the exclusive right to tax royalties in the country of residence of the licensor (which is the solution of the OECD Draft Convention) nor in the country of source (country of residence of the licensee) is a suitable solution for tax conventions between developed and developing countries. A fair solution can only be found by sharing this item of income between the residence and the source country for income-tax purposes. The guidelines contained in paragraphs 141-146 of the report of the third meeting of the Ad Hoc Group do not seem to be sufficiently clear and practicable. It is therefore suggested that a tax treaty provision on royalties;

(a) Would give the right to tax to both the residence and the source country;

(b) But would limit the tax in the source country to a withholding tax of 5 per cent on the gross amount of the royalties, which amount of tax the residence country should take fully into account in granting a credit of tax;

(c) And would oblige the source country, if it would wish a tax at source of more than 5 per cent on the gross amount, to apply such tax on the net amount of the royalty and at a rate which does not exceed one half of the normal income or profits tax on the total net income or profits (including net royalties from the source country) imposed in the country of residence of the recipient of the royalties.

ALTERNATIVE DRAFT OF ARTICLE 12:
SUGGESTION OF THE MEMBER FROM ISRAEL

Paragraph 1

Replace the existing text by the following one:

(a) Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

(b) However, [new] such royalties may be taxed in the Contracting State in which they arise, and according to the law of that State, but the tax so charged shall not exceed:

(1) Five per cent of the gross amount of the royalty, if at the end of the tax year concerned, less than one half of the period in which the patent, right or other property in respect of which the royalty arises, is protected has expired;

(2) Fifteen per cent of the gross amount of the royalty, if at the end of the tax year concerned, one half or more of the period in which the patent, right or other property, in respect of which the royalty arises, is protected, has expired.

Paragraph 2

After the words “scientific work”, delete the words “including cinematograph film”.

For “industrial, commercial or scientific equipment”, read “industrial or scientific equipment”.

For “industrial, commercial or scientific experience”, read “industrial or scientific experience”.

ARTICLES 23A AND 23B:
SUGGESTION OF THE MEMBER FROM ISRAEL

It is proposed to add to articles 23A and 23B an additional article, to be called article 23C, which will deal with the method for the avoidance of double taxation when a convention for this purpose is made between a developed and a developing country. The proposed article reads as follows:

ARTICLE 23C:
CONVENTIONS BETWEEN A DEVELOPED COUNTRY AND A DEVELOPING COUNTRY

1. Where the Contracting States are a developed country and a developing country, articles 23A and 23B shall not apply and the provisions of this article shall be put into effect.

2. Where a resident of a Contracting State, which is a developed country, derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, which is a developing country, the first-mentioned State, shall, subject to the provisions of paragraphs 3 and 4, exempt such income or capital from tax and shall not take it into account for the purpose of calculating tax on the remaining income or capital of that person (i.e., grant full exemption in respect of such income).

3. Where, however, a resident of a Contracting State, which is a developed country, derives income which may be taxed in the other Contracting State, which is a developing country, in accordance with the provisions of articles 10, 11 and 12 of this Convention, paragraph 2 of this article shall not apply, and the first-mentioned State shall allow as a deduction from the tax on the income of that person an amount equal to the tax paid on that income in that other Contracting State (i.e., grant full credit in respect of the tax paid on such income).

4. Where a resident of a Contracting State, which is a developed country, derives income which may be taxed in the other Contracting State, which is a developing country, in accordance with the provisions of articles 10, 11 and 12 of this Convention, and is granted a tax benefit in that other State in accordance with its taxation laws, the first-mentioned Contracting State shall allow as a deduction from the tax on such income of that person, an amount equal to the sum of the tax that would have been paid on such income in the other Contracting State had no such tax benefit been granted.

A PERMANENT INTERNATIONAL PANEL OF TAX EXPERTS AND ADMINISTRATORS: SUGGESTION OF THE MEMBER FROM ISRAEL

At the first meeting of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, in December 1968, the member from Israel suggested that the Ad Hoc Group recommend that the United Nations should set up an international panel of tax experts from which both developed and developing countries—and, in particular, the latter—could seek advisory opinions on specific technical cases and guidelines for negotiating and administering tax treaties. Members from other States supported the suggestion, and it was agreed to give it further consideration.

At the second meeting of the Ad Hoc Group of Experts, in April 1970, views were exchanged on the functions and activities of the proposed panel, and it was decided that the matter should be discussed further at forthcoming meetings of the Ad Hoc Group.

This opportunity is therefore taken to submit additional material which may assist members of the Ad Hoc Group when the matter is discussed at its forthcoming third meeting.

The material hereby submitted deals with the functions and activities that the proposed panel might take upon itself, or be requested to take upon itself.

1. Administrative assistance

In a work on developing countries and international fiscal law it is stressed that “the present system of Conventions is modelled upon the experience of the industrialized states; developing countries may not be able, with their present administrative equipment, to operate the highly refined system of taxation which such Conventions presuppose”.* Attention is drawn to “the lack of adequate machinery” and “a certain lag in administrative efficiency of developing countries”, as revealed and illustrated in tax case law

* Arthur Bergmann, Developing Countries and International Fiscal Law (Hanover, Verlag für Literatur und Zeitgeschehen, 1968).
It is also pointed out that the existing system of conventions fails to provide administrative assistance to developing countries in the collection of taxes.

It is considered that the proposed international panel of tax experts could act as an effective instrument for examining the administrative problems arising out of conventions for the avoidance of double taxation, both in general and in particular cases, and for examining ways and means of adapting such conventions to the basic tax and economic problems confronting the developing countries, with particular consideration to preventing the flight of capital, strengthening their reserves of foreign currency and constructing a broader and effective base for taxation.

2. [New] methods of allocation

The fiscal systems of Contracting States may differ on basic points (such as what constitutes deductible expenditure, rates of amortization for tax purposes, different methods of setting off losses for tax purposes and investment allowances). Conventions do not, therefore, always eliminate double taxation, since the income chargeable to tax in each of the Contracting States is assessed in accordance with the tax laws of each State. As the investment by residents of one State is the economy of another State becomes more and more widespread, this aspect of the “inadequacy” of current arrangements for the avoidance of double taxation is likely to grow. The development of “international” and “international” corporation business will inevitably raise problems of the allocation of taxable income and of the tax charged on such incomes between the various States in which such corporations are active. These developments make it desirable to consider the possibility of new methods of taxing the income derived from economic activities carried out by the same person in more than one State.

The proposed panel could serve as an effective instrument for studying this problem.

3. Improving relations between the tax administration and the taxpayer to produce higher revenue

In a report prepared by the Executive Secretariat of the Inter-American Center of Tax Administrators, the causes of friction between tax administrations and taxpayers are examined and proposals made with the objective of eliminating, or at least reducing them; and it is suggested that:
(a) Permanent programmes be developed in the field of public relations and information in order to educate and assist the taxpayer;
(b) Tax legislation be simplified in order to make it accessible (and comprehensible) to the taxpayer;
(c) Administrative procedures be simplified;
(d) Tax officials be given adequate training.

The permanent panel could act as an advisory body in these fields and even draw up model programmes.

4. Consultative machinery

The panel could serve as a body with which States, and especially developing countries, could consult with respect to the following matters:
(a) Interpretation of existing conventions, where special difficulties of interpretation arise in respect of particular points and provisions. Such practice might well contribute to the arriving at uniformity in the application of the provisions of conventions for the avoidance of double taxation;
(b) Giving of advisory opinions in respect of problems arising between Contracting Parties to conventions at an early stage, so as to assist them in formulating their standpoint;
(c) Giving of advisory opinions where decisions made by the national tax administrations of the Contracting Parties are in conflict one with the other—a situation likely to arise in highly technical matters, such as the allocation of income and deductible expenses between related enterprises;
(d) Giving of advice and the provisions of guidelines to developing countries about to enter into negotiations with another State in respect of a tax treaty, both in general and in respect of particular problems.
(e) Giving of advice in connexion with the incentives that a developing country is considering in order to encourage foreign investors so as to ensure their effectiveness, in the light of the tax laws of those developed countries whose residents are potential investors in developing countries.

5. Tax problems in developing countries

The proposed panel could undertake to examine and to proffer solutions to particular tax problems arising in or affecting developing countries, in particular, those connected with the provision and utilization of information, tax evasion and the flight of capital.

6. Glossary of terms and concepts

The proposed panel could draw up a glossary of terms and concepts used in tax legislation and tax treaties so as to secure a uniformity of definition and application and thus reduce to a minimum misunderstanding between Contracting States.

ALTERNATIVE DRAFT OF ARTICLE 8:
SUGGESTION OF THE MEMBER FROM THE PHILIPPINES
1. Profits from the operation of ships or aircraft in international traffic may be taxed by the State where the income is derived, in accordance with its national law.
2. However, such income from the operation of ships or aircraft in international traffic may be taxed by the State where the owner of the vessel is a resident, but a tax credit should be allowed for the tax paid in the foreign State.
3. All outgoing fares and freights for carriage earned in one State, including incidental earnings, shall be deemed to have been derived from that State.

ALTERNATIVE DRAFT OF ARTICLE 12:
SUGGESTION OF THE MEMBER FROM THE PHILIPPINES
1. Royalties paid to a resident of a Contracting State by a resident of the other Contracting State may be taxed in that other State.
2. However, such royalties may be taxed in the Contracting State where the recipient of the royalty is a resident, but a tax credit should be allowed for the tax paid in the other State. (May be removed by virtue of article 23B.)
3. The term “royalties” as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience. (Same as OECD Model Convention, paragraph 2.)
4. The provisions of paragraph 1 shall not apply if the recipient of the royalties, being a resident of a Contracting State, has in the other Contracting State in which the royalties arise a permanent establishment with which the right or property giving rise to the royalties is effectively connected. In such a case, the provisions of article 7 shall apply. (Same as OECD Model Convention, paragraph 3.)
5. Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention. (Same as OECD Model Convention, paragraph 4.)
Part Two

ISSUES RELATING TO TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Report of the Secretary-General to the *Ad Hoc* Groups of Experts
Part Two

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INTRODUCTION

In pursuance of Economic and Social Council resolution 1541 (XLIV), the Secretary-General prepared a series of studies to assist the Ad Hoc Group of Experts at its third meeting. These included detailed reviews of such matters as the taxation of shipping profits, taxation of royalties, issues relating to international income tax evasion and avoidance, and methods of elimination of double taxation, and exchange of information. The Group availed themselves of these papers as starting points for their discussions and suggested that further studies be made in other areas.
I. TAXATION OF SHIPPING PROFITS UNDER THE LAWS OF SELECTED DEVELOPING COUNTRIES

A. Profits from sea and air transport

A foreign or non-resident enterprise may be so considered either on the basis of nationality (place of incorporation), domicile or place of control and management.

Of the Latin American countries, Argentina uses the nationality test, and Brazil and Chile use both the nationality and the domicile test. Of those countries under the influence of the British tradition, Ghana, India and Israel use the test of place of control and management, while Pakistan combines that test with the nationality test. The Philippines uses the nationality test.

Foreign taxpayers are taxed, in principle, on sea and air transport profits from domestic sources. Profits generally considered to be from domestic sources are those arising from the operation of ships or aircraft between places in the country, as well as from carriage of passengers or cargo from a place in the country to a foreign destination.

APPORTIONMENT OF PROFITS

In India, a non-resident owner or charterer of a ship is chargeable to tax on profits on the sea and air transport business in the same way as a non-resident who carries on any other business in India. If the actual profits arising in India cannot be ascertained from the return of income and the accounts and documents accompanying it, the income liable to tax in India is usually computed on either of the following bases:

(a) By applying to the turnover or gross receipts in India such percentage of net profit as may be considered by the tax authorities to be reasonable;

(b) By first computing, in accordance with the Income-tax Act, the net profit of the non-resident enterprise in relation to its global operations and then taking the profit arising in India to be such proportion of the global net profit as the turnover or gross receipts in India bear to the global turnover or gross receipts. Where neither of these methods is appropriate for the ascertainment of the correct amount of profits, it is open to the tax authorities to adopt any other basis that may be considered suitable.

In Ghana, as a rule, the income assessed may be based on a fair percentage of the full sum receivable on account of the carriage of passengers, mails, livestock and goods shipped in Ghana. However, when the shipowner or charterer or the air transport operator produces a certificate issued by the tax authority of his country of residence concerning the ratio of wear-and-tear allowance to turnover, his taxable profits in Ghana should be a sum bearing the same ratio to his Ghana turnover as his world profit does to his world turnover. A similar provision exists in Israel.

In Ghana and Israel there is also a special provision exempting casual income from shipping or air transport from tax.

The laws of Argentina, Brazil, Ghana and Israel provide for reciprocal exemption of profits from sea and air transport. Chile, India and Pakistan have no such provisions for reciprocal exemption unless so provided in an agreement for the avoidance of double taxation.

B. Taxation of income from sea and air transport in selected countries

The laws governing taxation of sea and air transport in selected developing countries are briefly described below.

ARGENTINA

Enterprises incorporated outside Argentina are considered non-resident. They are taxable on 10 per cent of gross income from outgoing freights and passenger tickets sold in Argentina (rates: 38.36 per cent plus 7 per cent thereon of 10 per cent; effective rate, 4.1052 per cent). Non-residents are exempt subject to reciprocity.

BRAZIL

An enterprise that is incorporated and has its principal place of business abroad or has its domicile outside Brazil is considered a non-resident for income-tax purposes. Profits from domestic sources would be those arising from operations realized by the branch office of the enterprise authorized to operate in Brazil. Deductions are allowed only for expenses realized in the national territory.

Foreign airlines and steamship enterprises are exempt from Brazilian income tax if the country of their nationality grants a corresponding exemption to similar Brazilian enterprises.

CHILE

Enterprises not being domiciled or incorporated in Chile are non-residents. They are taxable on profits derived from assets located within the country or from activities practised therein.

1 See also section on Israel.
2 See also section on India.
When accounting records do not show local results, the Tax Bureau may assess taxable income by applying to the gross revenue of the agency the ratio existing between the total net income of the head office and its gross revenue. Alternatively, it may be computed by applying to its assets the same ratio existing between the net taxable income of the head office and its total assets. The tax rate applied is 59.5 per cent.

**Ghana**

An enterprise is considered non-resident if its "control and management" are exercised outside Ghana. Non-resident enterprises are generally taxable on the profits from domestic sources. Considered to derive from domestic sources are profits arising from the carriage of passengers, mails, livestock or goods shipped or loaded into a ship or an aircraft in Ghana. Items brought to Ghana solely for trans-shipment or for transfer from one type of transportation to another are excluded.

Full exemption is granted if the Commissioner of Income Tax is satisfied that an equivalent exemption is granted by the country in which the non-resident resides to persons resident in Ghana. Exemption may also be allowed when the commissioner of income tax is satisfied that the call of a ship or aircraft operated by a non-resident is casual or isolated or may not be repeated.

In practice, the commissioner of income tax may take into consideration, in determining what constitutes a fair percentage of turnover, such factors as the costs or expenses and reasonable rate of return upon the property used in transportation, or such factors as arrivals and departures, originating and terminating tonnage, originating revenues, pay rolls and tickets sold in the country.

**India**

A firm or an association of persons is said to be non-resident if the control and management of its affairs are situated wholly outside India. A foreign corporation recognized as a "company" in India for tax purposes is considered to be non-resident if the control and management of its affairs are not situated wholly in India. The test is where the control and management are situated. In the case of an incorporated enterprise, the control and management are, as a rule, situated at the place where the meetings of directors who manage and control the business are held.

Income accruing or arising in India or deemed to accrue or arise in India, or income received in the first instance in India by a non-resident or by any person on his behalf, is chargeable to tax in India.

Profits arising from the operation of ships in India in coastal traffic or inland waterways traffic and from carriage of passengers or cargo from an Indian port to a foreign destination are liable to tax in India as income accruing or arising in India. Likewise, profits arising from the operation of aircraft wholly or mainly between places in India, as well as from carriage of passengers or cargo from any place in India to a foreign destination, are liable to tax in India.

The profits derived by non-residents are not exempt subject to reciprocity, except if so provided in an agreement for the avoidance of double taxation of income.

**Israel**

An enterprise is considered non-resident if the control and management are exercised outside Israel; but a permanent establishment in Israel is considered resident, wherever controlled. A non-resident owner of sea and air transport is taxable on all income for passengers or cargo taken on board in Israel.

Where the non-resident owner of ships or cargoes submits to the Israeli tax authority a certificate from his own tax authority whose rules are approximately those applicable in Israel, tax is imposed on the relative net profit applicable in Israel, according to the relationship between income arising in Israel and total income. The law provides that where the country of residence of the ship or aircraft owner exempts profits of Israeli ship-owners, no tax will be imposed on the profits of ship-owners of that other country. This provision applies in almost all cases. A special provision also exempts casual income from shipping from tax in Israel.

**Pakistan**

All enterprises for which the control and management are situated wholly outside Pakistan and all enterprises incorporated outside Pakistan are considered non-resident. A non-resident is usually charged to tax on income that is received, accrues or arises in Pakistan.

With respect to shipping, this means that passenger and freight earnings from places in Pakistan are taxable. One sixth of freight earnings from ports in Pakistan are taxable at a rate applicable to a company. Alternatively, a shipping company may submit a return of income based on voyage accounts, or on the basis of Pakistan taxable income being determined in proportion of Pakistan freight earnings × World profits. Income from air transport is usually assessed in proportion of Total Pakistan earnings × World profits.

**Philippines**

Foreign enterprises not engaged in trade or business in the Philippines are considered non-resident. Non-resident enterprises are taxable on the profits from domestic sources.

The gross income of the non-resident carrying on sea and air transport business between the Philippines and points abroad consists of the gross receipts from outgoing freights and passengers from Philippines ports and non-shipping income received by the Philippine office of the non-resident. Net income is determined by deducting from the gross receipts from outgoing business such portion of the aggregate expenses, losses etc. as such receipts bear to the aggregate receipts from all ports.

There is no provision of law exempting the profits derived by non-residents on the basis of reciprocity.
II. TAXATION ON ROYALTIES RECEIVED BY NON-RESIDENTS UNDER THE LAWS OF SELECTED DEVELOPING COUNTRIES

A. General practices

In the report of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, it was generally agreed that the basic principles for the taxation of royalties and the positions expressed by the parties were similar to those applicable to interest.\(^1\)

As in the case of interest income, the payer is usually allowed, under the statutory tax law of most countries, a deduction in the computation of his taxable income for payments of both the categories. Thus, unlike dividends, royalties and interest do not, as a rule, suffer economic double taxation; that is, they are not usually taxed both in the hands of the debtor and in the hands of the creditor (see section on deductibility of royalties).

Like dividends, however, royalties and interest usually attract tax charged by deduction at the source when they are paid. This method is, in fact, commonly used for practical reasons, as the tax charged at the source can constitute an advance of the tax payable by the recipient in respect of his total income or profits. If, in such a case, the recipient is a resident of the country practising deduction at the source, any double taxation he suffers is remedied by internal measures. The position is different, however, if he is a resident of another country: he is then liable to be taxed twice, first by the State of source and then by the State in which he resides.

**Net or Gross Taxation**

As developing countries are particularly dependent upon the communication of advanced technology, substantial and continuing payments for these transfers are likely to cause balance of payments problems for them. For this reason, some developing countries feel constrained to insist on comparatively high withholding taxes. These countries include, in the group considered here: Brazil (25 per cent); Chile (37.5 per cent); Israel (25 per cent); and the Philippines (25 per cent; 35 per cent).

Since withholding taxes are usually levied on the gross amount of the payments, while the tax of the licensor's home country is computed on net income, they will frequently exceed the latter if allocable expenses are a higher percentage of gross income than the tax of the home country.

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\(^1\) Tax Treaties between Developed and Developing Countries (United Nations publication, Sales No. E.69.XVI.2), part one, para. 93.

### Table 1. Rates of Withholding Tax on Royalties: Selected Countries (Percentage)

<table>
<thead>
<tr>
<th>Countries</th>
<th>Corporation</th>
<th>Individuals</th>
</tr>
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<tbody>
<tr>
<td><strong>Gross taxation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>25.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Chile</td>
<td>37.5</td>
<td>37.5</td>
</tr>
<tr>
<td>Israel</td>
<td>25.0</td>
<td>25.0(^a)</td>
</tr>
<tr>
<td>Philippines (^b)</td>
<td>35.0</td>
<td>25.0</td>
</tr>
<tr>
<td><strong>Net taxation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina (^b)</td>
<td>41.0452</td>
<td>Sliding scale</td>
</tr>
<tr>
<td>Ghana</td>
<td>70.0</td>
<td>Sliding scale</td>
</tr>
<tr>
<td>India (^b)</td>
<td>50.0(^e)</td>
<td>33 or sliding scale, whichever is higher</td>
</tr>
<tr>
<td>Pakistan (^d)</td>
<td>60.0</td>
<td>30 or sliding scale, whichever is higher</td>
</tr>
</tbody>
</table>

\(^a\) Non-resident individuals requiring an assessment pay at sliding-scale rates. The 25 per cent is then applied on account of such assessment.

\(^b\) The 50 per cent automatic allowance, where the beneficiary habitually incurs research, development or other expense relating to the generation of royalties, makes an effective rate of 20.5226 per cent.

\(^c\) This is the rate for royalty agreements concluded after 31 March 1961, and technical fee agreements concluded after 29 February 1964. Otherwise, the rate is 70 per cent.

\(^d\) Tax withheld on gross payments.
Other countries tax royalties on the net amount, e.g., Ghana (70 per cent); India (50 per cent); and Pakistan (60 per cent).

The grantor of industrial patents and other expertise is essentially interested in the net return after the payment of the tax in the source country; and the rate of such tax is therefore an important consideration in the determination of the rate of royalty. Accordingly, where the rate of tax on the royalty in the source country is high, the rate of royalty will be correspondingly higher in order to assure to the grantor of the "know-how" the same after-tax return as he would have had if the rate of tax had been lower. Taking into account this consideration, the statutory tax law of India, for instance, provides for a concessional tax rate of 50 per cent (as against the normal rate of 70 per cent in respect of royalties received by a foreign enterprise under approved agreements entered into after a specified date). The concessional rate of 50 per cent on royalties payable to foreign enterprises compares favourably with the ordinary rate of 55 per cent applicable on such income of domestic enterprises.

It has been pointed out that one solution to these problems would be provided by a provision under which the developing countries would tax royalties on a net basis and at a moderate rate, or at a rate computed on gross income, more or less equivalent to the tax that would apply if a net basis were used. This suggestion gained some support in the discussions of the Ad Hoc Group of Experts. 

DEDUCTION FOR RESEARCH EXPENDITURE

In the countries that tax royalties on their net amount (Argentina, Ghana, India and Pakistan), expenses, including research expenditures, can be set against the gross amount of the royalty. In India and Pakistan, there is no fixed allowance for research expenditure.

In Ghana and Pakistan, expenses are allowable irrespective of where they are incurred, provided they are related to the process of earning the taxable income. In India, expenditure incurred by the non-resident outside India, wholly and exclusively for the purpose of earning royalty from India, is allowable as a deduction. Expenditure incurred in India may be a direct charge, whereas that incurred outside India may be charged in full, if it is direct, or in proportion if it is indirect.

DEDUCTIBILITY OF ROYALTIES AS AN EXPENSE TO THE PAYER

Some countries do not permit a deduction for royalties and technical-service fees, particularly where the payments are made to a foreign parent enterprise or other controlling interests abroad. Where such restrictions apply, the payments are, in effect, treated as dividends.

In Brazil, royalties payable to principal shareholders are not deductible for corporate tax purposes (and are taxed as dividends). This disallowance is due to the fact that the royalty route of investment lends itself greatly to abuse, particularly between controlled taxpayers, because it is not easy to determine the proper value of the expertise or the proper amount of royalty.

As a rule, royalty payments constitute a deductible expense of the payer. In some countries, however, particularly those which levy a gross withholding tax, royalties in excess of certain set percentages on sales prices of capital invested are disallowed (Argentina and Brazil); or they are disallowed if they are excessive and the recipient thereof is the owner, controlling stockholder or affiliate of the payer (Argentina, and the Philippines).

In Ghana, if the royalty exceeds a fair and reasonable consideration for the right used, it may not be allowed as a deductible expense to the paying enterprise. In India, royalty based on production or sales is deductible in arriving at the taxable income of the payer, unless the royalty is, in fact, paid for the acquisition of any capital rights whether total or partial.

LIMITS ON ROYALTY PAYMENTS

No specific limits are set on amounts of royalty payable to taxpayers abroad. Several countries, however, use indirect methods of discouraging excessive royalty payments. The Government of India, for example, will withhold its necessary approval of a royalty or technical fee agreement in practice, where the agreement provides for the payment of a royalty and/or technical fee exceeding 5 per cent on sales or production. The Central Bank of Chile may exercise control over royalty payments abroad by virtue of its responsibility for exchange control. In other countries, excessive royalties are disallowed as an expense of the paying enterprise.

SALE OF PATENT

In the discussion of the problem by the Ad Hoc Group, it was mentioned that agreements for the transmission of patents and know-how, in addition to providing for the reimbursement of current expenses for servicing the patent and for the sharing of research and development expenditures, often provided for lump-sum payments towards the cost of developing the patent of technology, which were tax-free in some source countries. Thus, in Israel, if a non-resident sells a patent developed abroad outright to Israel, no tax is due if the price is determined in a lump sum. Tax would be due on a patent developed in Israel by a non-resident and sold either in Israel or abroad.

4 Thus, as concerns the agreement between the United States of America and Brazil, the tax treatment of royalties is complicated by the fact that under Brazilian law, royalty payments are frequently disallowed as a deduction to the payer, as is true when they are paid by a Brazilian subsidiary to a parent firm in the United States. When royalties are disallowed as a deduction, Brazil, in effect, treats the royalty as a dividend.

2 Ibid., part two, para. 89.
3 Ibid., part one, para. 97. For an interesting example of such an approach, see material on Argentina in section B.
B. Practice in selected countries

ARGENTINA

In Argentina, royalties are taxed at the regular net corporate tax rates, or at the sliding-scale rate, if the beneficiary is a private person. In the case of royalties paid to beneficiaries outside Argentina, in general, the withholding tax rate is 41.0452 per cent on 50 per cent of the amount, when the beneficiary is a business enterprise; for a private person, the sliding-scale rate, on 50 per cent of the amount of the royalty, is applied.

An automatic deduction of 50 per cent is allowed when the foreign beneficiary normally incurs research expenses and only 50 per cent of the royalty is subject to withholding taxes. The 50 per cent allowance is deductible based on a sworn statement made by the foreign beneficiary that he incurs research expenses. In the case of local beneficiaries, the related expenses must be proved.

As concerns royalties for technical advice, the deduction for the payer is limited to 3 per cent on sales or 5 per cent on capital invested. If the royalties are paid within an economic group, the percentage must be in the limit of an "arm’s length" transaction; but the Tax Department may adjust excessive royalties. Any excess paid on what could be considered an "arm’s length" transaction could be treated as a remittance of profits and disallowed as an expense to the local enterprise.

BRAZIL

In Brazil, royalties payable to non-resident enterprises or individuals are subject to a withholding tax of 25 per cent on their gross.

Royalty contracts providing for excessive royalty rates will not be approved by the exchange control authorities. Charges in excess of certain limits are disallowed for corporate-tax purposes.

Royalties payable to principal shareholders are not deductible for corporate-tax purposes. In other cases, royalties are deductible up to certain percentage limits based on related sales, depending upon the nature of the industry, but never greater than 5 per cent on sales. Royalty expense not deductible for tax purposes is considered a dividend and is therefore subject to profits tax of 30 per cent in addition to the withholding tax of 25 per cent.

CHILE

Royalty derived from an industrial or intellectual property used in Chile by non-residents is subject to the withholding tax at the rate of 37.5 per cent on their gross amount.

There is no limitation on the rate of royalty from a tax standpoint, always provided that the royalty does constitute a normal and regular business expense. However, since the availability of foreign exchange for the payment of the royalty is subject to control by the Central Bank, the latter has formed a special committee which reviews each royalty agreement and, in practice, limits its amount in certain circumstances.

GHANA

Royalties are considered to be domestic when paid by a resident of Ghana or in connexion with a resident enterprise. Any person paying a royalty to a non-resident is empowered to withhold tax at the appropriate tax rate for personal or corporate income. The normal tax rates for personal or corporate income apply.

There is no fixed allowance for research expenditure which would normally be allowed on capital rather than annual expenditure basis. Expense deductions are allowed on the discretion of the Commissioner, but the taxpayer has the right of appeal. Expenses are allowable irrespective of where they are incurred, provided they are related to the process of earning the taxable income and are deductible from the income of the payer. Royalties are treated as rental expense, for the amount of royalty payable to taxpayers abroad. No specific limit is fixed. The amount involved must be a fair and reasonable consideration for the right for which the royalty is paid; otherwise, it may not be allowed as a deductible expense to the paying enterprise.

INDIA

Royalties are taxable in the hands of the non-resident recipient, as is all income accruing or arising through or from any source of income in India. Royalties are from an Indian source, for instance, if they are calculated on the basis of either production or sales in India.

The rate of tax, deductible at source, on royalty and technical payments to non-resident "companies" (which must be registered as such) is 50 per cent, where the agreements were registered after 31 March 1961 (in the case of royalties) or 29 February 1964 (in the case of technical fees); otherwise, the rate is the general one of 70 per cent. Non-resident individuals pay at the same rate as residents; 33 per cent (25 per cent income tax, plus 8 per cent surcharge) is deductible at source from such payments. This is effectively the minimum tax payable by a non-resident, other than a registered non-resident "company".

There is no fixed allowance for research expenditure. It can be claimed if it is directly attributable to royalty receivable from India, or if the whole of the expenditure is allocated pro rata to royalty receivable from India and from other countries. In practice, it is difficult to obtain the allowance of such expenditure against royalty. Comparatively speaking, expenditure (including research expenditure) incurred in rendering technical services is being more easily allowed in arriving at the income from technical fees accruing or arising in India. The allowance will be based on the taxpayer's declaration, which is used as a basis for agreement with the tax authorities.

5 An enterprise incorporated outside India has to apply and obtain an order of the Central Board of Direct Taxes declaring it as a "company" for the purposes of Indian income-tax. Otherwise, a foreign corporation is treated as an "association of persons". The rates of tax applicable to a non-resident company and a non-resident association of persons differ.

6 Income tax, 5-65 per cent, plus surcharge, 20-25 per cent, plus 10 per cent special surcharge on income tax plus surcharge.
Expenditure incurred by the non-resident outside India wholly and exclusively for the purpose of earning royalty from India may be a direct charge, whereas that incurred outside India may be charged in full if it is direct or in proportion if it is indirect.

There are no statutory limits for the amount of royalty payable to a non-resident. In practice, however, the approval of the Government of India, which is required for all technical collaboration agreements with non-residents, is withheld where the agreement provides for the payment of a royalty or technical fee, or both, exceeding 5 per cent on sales or production.

Royalty based on production or sales is deductible in arriving at the taxable income of the payer, unless the royalty is, in fact, paid for the acquisition of any capital rights, whether total or partial.

**ISRAEL**

In Israel, there are no limits set for the amount of the royalty payable to taxpayers abroad, unless there is reason to suppose that the amount payable is fictitious, or as will be found in certain double-taxation agreements where the amount exceeds what normally seem to be reasonable. The royalties are subject to a withholding tax where payable to non-residents. The withholding rate is usually 25 per cent on the gross.

There is no fixed allowance for research expenditure, but the standard withholding rate of 25 per cent assumes a certain level of expenses. If no assessment is required, the withholding rate of 25 per cent is considered final. If an assessment is required, expenses have to be proved; but, generally speaking, the declaration of a non-resident taxpayer would be accepted, provided that the expenses claimed are, in principle, allowable. The allowances are not restricted to those included within the country.

The royalty is deductible from the income of the payer if it is incurred in earning income liable to tax.

If a non-resident sells a patent developed abroad outright to Israel, no tax is due if the price is determined in a lump sum. Tax would be due on a patent developed in Israel by a non-resident and sold either in Israel or abroad. If the patent is part of the ordinary business of the taxpayer, he would be taxed at ordinary rates. If not, a special flat rate of 25 per cent would apply.

**PAKISTAN**

Royalties derived from any asset or source in Pakistan are subject to tax, deductible at source, at normal business rates, that is, 60 per cent for non-resident enterprises and slab rates, or 30 per cent, whichever is the greater, for non-resident individuals.

There is no fixed allowance, any allowance being made in agreement with the tax administration, which, in practice, is difficult.

There are no limits on royalty payments abroad. Royalty payments are deductible by the payer.

**PHILIPPINES**

Royalties from domestic sources (for the use of or for the privilege of using, in the Philippines, patents, copyrights, secret processes and formulae, goodwill, trademarks, trade brands, franchise and other like property) are taxable at 25 per cent to non-resident aliens not engaged in trade or business in the Philippines and 35 per cent to non-resident foreign enterprises (that is, the normal rate for payments to non-residents). Royalties paid to non-residents are taxed on their gross amount. No allowance is given for research expenditure.

There are no stipulated limits on royalty payments abroad, but they should be not excessive.

The payer may deduct the payments from his income, subject to the following provisions. Royalty payments are deemed to be dividend payments when the amount of the royalty is excessive and the recipient thereof is the owner or controlling stockholder or affiliate of the payer. The portion of the royalty deemed to be a dividend is disallowed as a deduction to the payer, whose adjusted income is then taxed at the regular rate.

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7 Graduated rates (from 3 to 70 per cent) for citizens, resident aliens and non-resident aliens engaged in trade or business in the Philippines; 25 per cent for non-resident aliens not engaged in trade or business in the Philippines; 25 per cent on first 100,000 Philippine pesos and 35 per cent on excess for domestic and resident foreign enterprises; and 35 per cent on non-resident foreign enterprises.
III. THE SCOPE OF ROYALTIES

A. General considerations

Tax treaties invariably classify income that a resident or business enterprise of one of the treaty countries derives from sources in the other country in broad categories, such as business income (industrial or commercial profits), income from personal services or income from real property. As a result of the wide sweep of these classifications, the tax treatment of a particular category does not always fit all of the various types of income included in it. This problem has arisen, in particular, with respect to royalty income; and, specifically, certain types of income that are either in the nature of royalties or closely related thereto, namely, rentals of tangible personal property, film rentals, copyright royalties and mineral royalties.

There are various ways of dealing with these types of income in a tax treaty. One possibility is to treat them (with the exception of mineral royalties) in the same manner as other royalties. Another approach would be to classify these items as business income (industrial or commercial profits). If either category is found unsuitable for one reason or another, the question arises whether special treaty rules should be developed for these types of income. There is also the possibility of eliminating these items entirely from the coverage of a tax treaty and applying the local law of the contracting countries to them. The last-named approach is obviously not a real attempt at solving the problem, but rather an admission that an acceptable treaty solution cannot be found.

The question of the proper classification of income for treaty purposes is not so much a problem of legal analysis as of the preferences of the contracting countries concerning the practical effects that flow from one or the other characterization. Developing countries are not likely to favour classifying the types of income here discussed as royalties, which, according to the usual treaty practice, are either exempt from the tax of the source country or subject only to a limited withholding tax.1 Neither will they be inclined to classify this income as industrial or commercial profits and thus forgo their tax jurisdiction over it unless the income is attributable to, or effectively connected with a permanent establishment maintained by the lessor in the taxing State.2 The same rule may well apply under the numerous treaties that made no mention of this particular item of income and, in particular, do not include it in their royalty article. Under those treaties, the tax jurisdiction of the source country over this income would be preserved, at least where the treaty does not include a provision similar to article 21 of the Organiza-

1 See Tax Treaties between Developed and Developing Countries (United Nations publication, Sales No. E.69.XVI.2), part two, paras. 79-90.
2 See the alternative draft of article 7 of the OECD Model Convention suggested by the Indian member of the Ad Hoc Group of Experts. Ibid., part one, p. 29. According to this proposal, certain types of income, including rents, film rentals and television rentals, are to be eliminated from the term “profits” unless the property or right giving rise to the income is effectively connected with a permanent establishment in the country in which the property or right is put to use. Income of this kind is to be taxed in the manner specified in other provisions of the Convention; or, in the absence of specific treaty provisions, in accordance with the local law of the Contracting States.

B. Rentals of tangible personal property

Rentals of tangible personal property are not often specifically covered in bilateral tax conventions, in part, perhaps, because international leasing transactions are a comparatively recent development. In some treaties concluded by the United States of America, the maintenance of substantial equipment or machinery by an enterprise of one of the contracting countries in the other country constitutes a permanent establishment of the enterprise in that country.3 This treaty clause, however, applies primarily to direct operations by an enterprise in the other treaty country, and not to rentals or leases of equipment to a resident of the country in which the equipment is put to use.

Only a few treaties between industrialized and developing countries include rentals of tangible movable property in the term “industrial or commercial profits”,4 while a much greater number of these treaties specifically exclude rentals from that term.5 At least one treaty specifies that rentals are to be taxed in conformity with the law of the contracting countries unless they are attributable to a permanent establishment maintained by the lessor in the taxing State.6 The same rule may well apply under the numerous treaties that made no mention of this particular item of income and, in particular, do not include it in their royalty article. Under those treaties, the tax jurisdiction of the source country over this income would be preserved, at least where the treaty does not include a provision similar to article 21 of the Organiza-
It has been observed that leases of modern machines (such as computers) contain an element of royalties because of the high technological component of this equipment, which is reflected in the sales prices or rentals that are charged for it. For this reason, perhaps, a number of recent conventions between industrialized countries (as well as article 12, paragraph 2, of the OECD Model Convention) include among royalties payments for the use, or the right to use, industrial, commercial or scientific equipment.

There are, of course, strong similarities between rentals of tangible personal property of this kind and licences of intangibles. In both cases, advanced modern technology is made available to the lessee or licensee at a price that reimburses the owner for the cost of development and assures him of an adequate (in some cases, an extraordinary) profit. On the other hand, there are significant differences. Unlike the licensor of a patent, the lessor of tangible property is not compelled to police the quality of the products manufactured by the lessee or to take action against infringements of his rights. In the absence of a contractual obligation, he is not required to render technical assistance or to communicate improvements in the art to the lessee. Another difference is that the financial risk from long-term leases can, in some cases, be limited or eliminated by canalizing transactions through an independent leasing firm which guarantees performance by the lessee in return for a moderate, but assured income. These considerations may possibly justify a somewhat higher source tax on rentals of tangible property than on royalties from intangibles.

As a matter of legal theory, a case could be made for characterizing rentals from the leasing of tangible personal property as industrial or commercial profits. Especially in the case of an enterprise whose only or principal business is the leasing of equipment, there is no convincing reason why this activity should be characterized differently from that of an entity engaged in manufacturing or trading. The same argument could also be made where rental activities are only one of several lines of business. The practical difficulty with this characterization is that the lessee’s country of residence will not be able to tax the rentals in the absence of a permanent establishment maintained by the lessor in its area and, for that reason, may object to the characterization.

On the other hand, taxation of the rentals according to the local law of the lessee’s country of residence may be unacceptable to the lessor unless there is assurance that the lessor’s home country will take adequate steps to prevent the double taxation of the income. There is no convincing reason why the taxation of the rentals should not lend itself to mutual accommodation, as is the case for numerous other types of income. Considering the similarity of rentals and royalties, it would seem that taxation of rentals either on a net basis at full rates, or on the basis of gross income at low rates, might be an equitable and mutually satisfactory solution, as in the case of royalties.

C. Film rentals

Film and television rentals pose specific problems which are not present in the case of industrial royalties or fees for the communication of industrial or commercial know-how. Comparatively few countries, primarily the United Kingdom of Great Britain and Northern Ireland and the United States of America, are major film exporters. Consequently, there is seldom, if ever, a reciprocal flow of income of approximately equal magnitude from this source between any two countries. Another characteristic feature of the film industry is the strikingly uneven flow of income resulting from the fact that the audience response to a cinematograph film can never be precisely forecast; consequently, a high percentage of all films made produce little or no income after their initial exhibition.

Industry figures in the United States of America indicate that the over-all cost of a cinematograph film equals at least 90 per cent of the gross revenue and often more than that. This high cost of producing films is, to some extent, reflected in the reduced withholding rates which a number of countries apply to film rentals paid to foreign producers, as discussed below.

TAX TREATIES

A survey of about 90 tax treaties concluded between 1957 and 1968 discloses that film rentals are included among royalties in about 60 conventions and characterized as industrial or commercial profits in about 20 others. Approximately 10 conventions (mainly with developing countries) include special rules on film rentals or leave the taxation of this income to the local law of the contracting countries. The special rules in reference

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7 Article 21 of the OECD Model Convention provides that those items of income of a resident of a Contracting State which are not expressly mentioned in other articles of the Convention shall be taxable only in the country of residence. See Organization for Economic Co-operation and Development, Draft Double Taxation Convention on Income and Capital: report of the Fiscal Committee (Paris, 1963), p. 117.

8 Ibid., p. 117.

9 See Organisation for Economic Co-operation and Development, Fiscal Incentives for Private Investment in Developing Countries: report of the Fiscal Committee (Paris, 1965), para. 180; and United Nations, Tax Treaties between Developed and Developing Countries, part one, para. 89.

10 See Tax Treaties between Developed and Developing Countries, part one, para. 94.

11 On this ground, depreciation of cinematograph films on a "flow-of-income" basis is advocated. See United States of America, Revenue Ruling 60-358, 1960-2 Cum. Bull. 68. The prevalent practice in the United States of America, however, is to write off the cost of cinematograph films (including production and print cost) on the basis of a fixed time schedule (usually not less than two years) beginning from the time of the first release of the film, without taking the flow of income into account. This write-off considers a residual value for the use of the cinematograph film on television.

12 See Austria-United Arab Republic (1962); Brazil-Japan (1967); Federation of Malaya-Japan (1963); Finland-United Arab Republic (1965); Japan-New Zealand (1963); Japan-Thailand (1963); Norway-United Arab Republic (1964); United Arab Republic-United States of America (1960, not ratified). Some treaties refer expressly to the local law of the Contracting States. The same
to film rentals may consist in subjecting this income to a higher (e.g., in some agreements with developing countries) or lower withholding tax in the source country than that which applies to royalties, or in specifying a withholding tax on film rentals where royalties are not covered by the treaty.

**Unilateral rules**

Recognizing the fact film rentals include a significant cost component, a number of countries subject this income to withholding rates lower than those which apply to other types of income of non-residents. The reduced withholding taxes which are collected in the absence of a tax treaty may be prescribed by statute or may be applied as a matter of administrative practice. A few representative withholding rates are listed below:

- Argentina: 16.5 per cent (corporate rate of 33 per cent applied to 50 per cent of rentals);
- Australia: 4.4.5 per cent (corporate tax of 40 per cent or 45 per cent on 10 per cent of gross rentals);
- Belgium: 3 per cent (20 per cent tax applied to 15 per cent of rentals);
- Brazil: 12 per cent (40 per cent tax applied to 30 per cent of rentals);
- Canada: 10 per cent;
- Federal Republic of Germany: 5 per cent (administrative practice);
- Israel: 7.35 per cent (corporate tax of 49 per cent computed on 15 per cent of rentals);
- Malaysia: 15 per cent “film-hire duty” (25 per cent of 60 per cent of gross film rentals);
- Mexico: 6 per cent (administrative practice);
- New Zealand: 5 per cent (corporate tax of 50 per cent applied to 10 per cent of rentals), plus “film-hire duty” of 6 per cent (10 per cent of 60 per cent of gross film rentals) on British films or 15 per cent (25 per cent of 60 per cent) on non-British films;
- Philippines: 35 per cent;
- South Africa: 11 per cent (36.66 per cent tax computed on 30 per cent of rentals; proposed tax increase to 40 per cent will raise tax on film rentals to 12 per cent);
- Turkey: 20 per cent plus compulsory loan;
- Venezuela: 3.75-12.5 per cent (graduated tax rates of 15-50 per cent applied to 25 per cent of gross rentals).

Some countries tax film rentals at the regular corporate rates applied to the net amount of the income, e.g., Ghana (70 per cent), India (70 per cent) and Pakistan (60 per cent). In the case of individual recipients of such rentals, graduated tax rates are substituted for the flat corporate rates.

In evaluating the total tax burden on film rentals, account must be taken of the fact that a significant number of countries impose transactions taxes or excise taxes (such as the turnover taxes in the Federal Republic of Germany and in France or the film-hire tax in New Zealand) in addition to income-taxes at statutory or treaty rates.

**Special problems of developing countries**

As a matter of experience, film rentals paid to foreign producers or distributors constitute a heavy burden on the balance of payments of many developing countries. It is sometimes claimed that this adverse effect should be compensated, at least in part, by comparatively heavy withholding taxes on film rentals paid to non-residents. Substantial taxation of this income in the source countries is further defended on the ground that the country in which the income from the exhibition of a cinematograph film is produced should have the primary right of taxation with respect to the income. It is apparent from the foregoing tabulation of autonomous withholding rates that not all countries share this view.

Taxation of film rentals under the heading of royalties, which is the rule under the conventions, does not necessarily imply that the income is exempt from the tax of the source country. A significant number of treaties permit the source country to levy a limited withholding tax on royalties, and this method of taxation may be particularly apposite where the flow of income is not reciprocal. It should also be considered that a withholding tax computed on gross income is merely a substitute for an assessed income tax computed on net income, and that the rate of the withholding tax on film rentals should give recognition to the limited profit margin in the cinematograph film industry.

From the point of view of the industry, a cinematograph film is an industrial product which, as such, is not essentially different from tangible manufactured products. According to this view, the income from leasing a film to a foreign distributor is in the nature of industrial profit or commercial profits, although as a matter of legal form, the distribution contract is usually cast in the form of a licence under copyright combined with a lease of the positive print. While it may have been true in the past that cinematograph films were made for the home market rather than for the entire world, that is not the current situation. Such limited statistical information as can be obtained from cinematograph film producers in the United States of America discloses that the revenue from foreign sources amounts to not less than one third, and more frequently to about one half, of the total income

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13 The withholding rate on film rentals is 15 per cent under the treaty between Israel and the United Kingdom (1962), which exempts royalties from the tax of the source country.

14 The treaty between Canada and Norway (1960) provides for a 10 per cent withholding tax on film rentals and a 15 per cent tax on royalties.

15 This is the case under the treaties of the Philippines with Denmark (1960) and Sweden (1960), which provide for a 10 per cent withholding tax on film rentals.

16 See Tax Treaties between Developed and Developing Countries, part one, para. 84 (b).
from a film. According to the same sources, income from developing countries constitutes a significant portion of the total revenue. Accordingly, there seems to be merit to the assertion that the cost of a film should be allocated on the basis of revenue from both domestic and foreign sources, including the developing countries.

In connexion with the question of the scope of business profits, the members of the Ad Hoc Group from developing countries expressed themselves strongly in favour of eliminating film rentals from the concept of business profits so as to permit their taxation even in the absence of the permanent establishment. They conceded, however, that only that portion of the income which could be considered to have the source in their area should be taxed.

Furthermore, in connexion with the question of the scope of royalties, they also favoured the exclusion of the film rentals from the scope of article 12 dealing with royalties (which, under the current OECD Model Convention, are exempt from tax in the country of source). Since, in that case, no specific provision would remain applicable to film rentals, under the proposed paragraph 8 of article 7 on business profits suggested by the member from India, the law in force in either of the Contracting States would govern the assessment and taxation of such income in the respective Contracting States.

The annual report of one major film producer in the United States of America, for the year ended 31 August 1968, shows total gross revenue (including television distribution and production royalties) of $210,292,000, of which $78,045,000, or about 37 per cent, was from sources outside the United States of America and Canada. Information compiled by the Motion Picture Export Association of America, Inc. over the past 10 years shows that, on average, 46.75 per cent of gross billings (not including television revenue) was derived from the United States and 53.25 per cent from other countries.

The annual report of the film producer referred to in footnote 17 shows the following geographical distribution of revenue from sources outside the United States of America and Canada:

<table>
<thead>
<tr>
<th>Region</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>British Commonwealth</td>
<td>18,810,000</td>
</tr>
<tr>
<td>Europe</td>
<td>30,025,000</td>
</tr>
<tr>
<td>Asia and Africa</td>
<td>14,862,000</td>
</tr>
<tr>
<td>Other countries in western hemisphere</td>
<td>14,348,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>78,045,000</strong></td>
</tr>
</tbody>
</table>

The two last-named items amount to $29,210,000, or about 14 per cent of the total revenue of $210,292,000.

Similarly, information compiled by the Motion Picture Export Association of America, Inc. shows that of the $325 per cent of total revenue derived from sources outside the United States of America, 39.65 per cent was from industrialized countries and 13.6 per cent from developing countries.

The method applied for amortizing the cost of a cinematograph film is of little help in resolving the question discussed in the text where amortization is required to be computed on a time basis rather than a flow-of-income basis. In the United States of America, cinematograph films are amortized over a period of either 18 or 24 months regardless of cost. Amortization on a flow-of-income basis is required by the United States Internal Revenue Service with respect to the "television residual," which frequently, but not uniformly, is fixed at 15 per cent of the cost of the film.

See Tax Treaties between Developed and Developing Countries, part one, para. 55; and, for proposal of member from India, ibid., p. 29.

21 Ibid., part one, para. 92.

D. Copyright royalties

**STATUTORY LAW**

Under the statutory law of most countries, copyright royalties paid to non-resident authors, publishers or other licensors are taxed according to the same rules as other royalties, i.e., they are usually subject to a withholding tax computed on the gross amount of the income. Under the law of some countries, these royalties are classified as business income or income from independent personal services and are taxed on a net basis and at regular individual or corporate rates. A few countries, such as Argentina, Canada and France, grant preferential tax treatment to copyright royalties.

**INQUIRY BY UNITED NATIONS: 1957-1958**

The problem of the double taxation of authors' royalties was taken up in resolution No. 11/11 of the Intergovernmental Copyright Committee.

At the request of the United Nations Educational, Scientific and Cultural Organization (UNESCO), the United Nations, in 1957-1958, 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 domestic legislation, apart from measures for avoiding the double taxation of such income. With respect to the latter point, 10 of 17 replies received favoured the inclusion of provisions on copyright royalties in bilateral tax conventions, 4 expressed themselves in favour of a standard clause, and 4 others expressed preference for a multilateral tax treaty dealing specifically with copyright royalties.

**TAX TREATIES**

In the great majority of cases, the tax conventions treat copyright royalties in the same manner as industrial royalties, i.e., they assign the primary right to tax this income to the country of residence of the licensor and provide for exemption or a limited withholding tax (usually, 10 per cent or 15 per cent) in the source country.


23 The replies of the Governments indicated that, at that time, a significant number of countries exempted at least a portion of authors' royalties from income tax under their local laws, or taxed such royalties at a reduced rate. Countries in this group included Argentina, France, Mexico, South Africa and Turkey. Certain other countries exempted such income, derived from sources in their territory, under certain conditions, e.g., if the royalties were earned in the course of a professional activity exercised through a permanent establishment. Countries in this group included Denmark, Iceland, Netherlands and Switzerland, as well as Belgium, according to administrative practice. Canada exempted copyright royalties (but not film rentals) paid to non-residents.

24 Tax Treaties between Developed and Developing Countries, part one, paras. 82 and 84. Certain treaties concluded by India assign the exclusive right to tax copyright royalties to the source country. See treaties of India with Austria (1963), Denmark (1959),
A limited number of treaties provide for preferential treatment of copyright royalties, except where the income is attributable to, or effectively connected with, a permanent establishment maintained by the licensor in the source country. Unlike industrial royalties, copyright royalties are exempt from the tax of the source country under the treaties of Canada with Australia (1957), Ireland (1966), Norway (1960) and Trinidad and Tobago (1966); the treaties of Israel with France (1963) and the United States of America (1965, not ratified); and the treaties of Ceylon with Denmark (1963), the Federal Republic of Germany (1962), Norway (1964) and Sweden (1957). Under the treaty between the Federal Republic of Germany and Thailand (1967), the withholding tax on copyright royalties paid in consideration of the use of, or the right to use, literary, artistic or scientific works is reduced to 5 per cent, while other royalties are taxed at the rate of 15 per cent. Some treaties extend the exemption from the tax of the source country to gains from the disposition of the property or right from which the royalties are derived.

**E. Natural-resource royalties**

Copyright royalties pose few problems that are not also present in the case of industrial royalties. As it would scarcely be practical to draw a distinction between various copyright royalties according to whether the income is paid to non-resident publishers or non-resident authors or their successors in interest, nothing would be gained by treating this income in some instances as industrial or commercial profits and in others as income from an independent professional activity or as income from capital, depending upon the characteristics of the recipient.

Some treaties list a fixed base for carrying out professional or other independent activities, in addition to a permanent establishment.

One major difference between copyright royalties and industrial royalties, in the context of treaties between industrialized and developing countries, is that the flow of income is by no means as one-sided in the case of the former as it is for the latter. Many countries that are economically less developed make important contributions to international intellectual exchanges. Consequently, the exemption of this income at the source, or the limitation of the tax of the source country to a low withholding rate, will benefit authors and other licensors in developing countries. In the absence of such limiting treaty provisions, the income is subject to high withholding taxes in some industrialized countries, e.g., a tax of 41.25 per cent in the United Kingdom or one of 30 per cent in the United States of America.

Special problems of developing countries

Copyright royalties pose few problems that are not also present in the case of industrial royalties. As it would scarcely be practical to draw a distinction between various copyright royalties according to whether the income is paid to non-resident publishers or non-resident authors or their successors in interest, nothing would be gained by treating this income in some instances as industrial or commercial profits and in others as income from an independent professional activity or as income from capital, depending upon the characteristics of the recipient.

Finland (1961), Norway (1959) and Sweden (1958). It is interesting to note that article X of the Mexico Model Convention of 1943, which generally assigned tax jurisdiction over royalties to the country where the royalty-producing right or property was used, reserved the taxation of copyright royalties to the country of the licensor’s domicile. This rule was adopted for all royalties by the London Model Convention of 1946. See League of Nations, Fiscal Committee, *London and Mexico Model Conventions: Commentary and Text*, document C.88.M.88 1946.II.A (Geneva, 1946).

25 Some treaties list a fixed base for carrying out professional or other independent activities, in addition to a permanent establishment.
IV. CONCLUSIONS OF COUNTRY RESPONSES ON INTERNATIONAL INCOME-TAX EVASION AND AVOIDANCE

At the second meeting of the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, the Secretary-General of the United Nations Conference on Trade and Development (UNCTAD) submitted a request to consider the issue of tax evasion and avoidance with special reference to potential, as well as actual, income information exchanges under current bilateral treaties and domestic law. The Ad Hoc Group was also asked to consider measures, apart from bilateral treaties, that could be used to discourage capital outflow from developing countries. The Ad Hoc Group discussed that issue and agreed that it needed further intensive study. In that connexion, the United Nations Secretariat prepared a questionnaire on international tax evasion or avoidance. To date, more than 40 responses have been received from Governments.

A. Nature of international tax evasion and avoidance

By definition, the term "international tax evasion" encompasses the willful, deliberate violation of law in order to escape payment of a tax on international income which is unquestionably imposed on that income by the laws of the taxing jurisdiction. No Government had available statistics respecting the extent of revenue loss or funds outflow resulting from international income-tax evasion. Nevertheless, it appears the concern about international tax evasion assumes two general forms: first, non-disclosure of income; and secondly, misleading disclosure of income, deductions or credits. Specifically, the responding countries mentioned a failure to file tax returns, failure properly to report income or other items and, in certain instances, inconsistent characterizations of income as constituting the most prevalent methods of international tax evasion.

Developing countries with a relatively small posture in foreign trade and investment did not consider international tax evasion a serious problem. Similarly, in most developed countries, it was believed that domestic legislation coupled with vigorous tax administrations had reduced the problem to acceptable levels. By contrast, international tax evasion was viewed as a serious problem by developing countries substantially engaged in world commerce.

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. The United States of America was, in particular, concerned about the use of foreign entities by non-resident aliens to avoid withholding taxes. Further, developing countries also specified undisclosed foreign-source wages and salaries, especially where a number of their nationals were employed abroad. Lastly, developing countries substantially engaged in international trade cited an apparent solution in the pricing of some imports far beyond the scope of the "arm's-length" standard employed for such transactions. These countries also mentioned overstatement of expenses, particularly head-office expenses for services rendered and salaries to directors paid abroad.

In contrast to international tax evasion, tax avoidance lacks the characteristic of illegality. Yet, due to certain legal practices, substantial amounts of revenue are lost in certain countries. Inducements for tax avoidance are: flexibility of available legal forms (personal holding companies, holding companies in general, limited partnerships, trusts and bearer shares); tax haven countries with low (or zero) income-tax rates or tax exemption of foreign-source income; favourable tax treaties with other countries; and secrecy laws. In addition, techniques for shifting business profits include income reallocation through the use of transfer pricing, management fees, royalties and intra-company loans. Most responding Governments cited both the substantive and the procedural aspects of international income reallocation between related entities as one of their prime concerns with respect to tax avoidance. As yet, however, only a few developed countries have adopted measures attempting to deal with the situation.

Some developed countries expressed concern about the use of favourable legal forms, tax havens, abuse of certain tax incentives, and tax treaties as vehicles for tax avoidance. For instance, expatriated investment income is routed through countries with which a tax treaty exists in order to secure a lower rate of withholding tax. Another form of tax avoidance involves the setting up of foreign corporations by non-resident aliens deriving substantial amounts of service income within a country. Under many tax treaties, a non-resident alien's income is exempt if his services are performed for a foreign corporation and the non-resident alien is only present in the country for a limited time during the year.

Lastly, the problem of the foreign holding companies was mentioned by only a relatively few developed countries, possibly because it is a legal avoidance technique.
under the laws of many countries or may be effectively dealt with on a unilateral basis.

B. Current measures to deal with international tax evasion and avoidance

The effect of international tax evasion or avoidance is an unwarranted exemption from or deferral of taxes. The responding Governments specified both tax and non-tax measures designed to meet the problem. Tax measures included unilateral legislation and bilateral treaty enactment.

Unilateral tax legislation, primarily enacted in developed countries with substantial investments abroad, has attempted to meet the issues on two levels. On the first level are laws requiring disclosure of information relevant to the structuring of transactions and business enterprises with tax evasion and avoidance aspects. When such statutes are complied with, tax administrators receive the information that assists them in evaluating the applicability of substantive provisions. For instance, some tax authorities are empowered to require nominees to declare on whose behalf income from "bearer share" securities has been received. The substantive provisions usually approach the problem by requiring a deemed repatriation of income, thus nullifying tax exemption or deferral potential.

Perhaps the most prelevant substantive legislation is directed against individuals who attempt to avoid taxation on personal investment income through the setting-up of a foreign corporation to hold such investments for them. As a rule, the holding company is in a tax haven country so that local taxation is minimal. Some countries have met the problem of the personal holding company by requiring a deemed distribution of the passive income of such enterprises.

Another situation causing serious tax avoidance potential occurs in those countries which adhere to the "title passage" test for determination of income source with respect to sales of tangible personal property. The title passage rule has resulted in the establishment of foreign-based enterprises in low tax rate countries in order to absorb as much profit potential as possible in sales of personal property before resale of such property in the country of ultimate destination. To mitigate the tax abuse arising from that situation, a number of developed countries have adopted legislation requiring a constructive repatriation of income from a foreign-based enterprise in much the same manner as income from a personal holding company.

Lastly, a number of responding countries alluded to general statutes and regulations concerning income reallocation. Income reallocation statutes usually are applied to the taxpayer who has failed to show that an arm's length or similar standard was used in dealing with a related party. Although the scope of income reallocation statutes extends to all business transactions between related parties, applications to potential tax evasion and avoidance has proved promising.

Procedurally, few responding Governments indicated a willingness to furnish tax information on a unilateral basis, even when a specific request was received. No responding Government stated that it would enforce collection of delinquent taxes for a foreign country on a unilateral basis.

Bilateral tax treaties have been far more successful in providing a framework for international co-operation in tax assessment and collection. The majority of tax treaties specifically provide for exchange of information between the tax administrators of the signatory countries. Under such provisions, large quantities of routine taxpayer information are disseminated, primarily by relatively few developed countries. France and the United Kingdom have a large number of tax agreements with their former dependencies. Exchange of information with the former metropolitan country appears to assist them in taxing income where administrative difficulties do not diminish the value of the information. Furthermore, many tax treaty partners exchange information on relevant tax laws and administrative regulations. Most of the responding Governments, however, reported an almost complete lack of specific requests for information from tax treaty partners. This result may be partially due to the difficulty at first in detecting tax evasion or avoidance. Hence, it would be difficult to discern what specific information would be essential to a particular case. In addition, a number of responding countries cited secrecy laws, which substantially preclude disclosure of taxpayer information beyond that which is routinely given, as a major cause for not making specific requests.

Clauses providing for general assistance in collection of taxes are currently to be found in relatively few tax treaties. More frequent are clauses calling for limited assistance in collecting taxes, to the extent that such collection is necessary to assure that exemptions or reduced rates under treaties are not enjoyed by persons not entitled to such benefits.

It should also be mentioned briefly that a number of non-tax measures exist, the most important of which is exchange control, which mitigate the potential of international tax evasion and avoidance.

C. Future steps to promote information exchanges

While the encouragement of unilateral legislation to expand information exchange may appear promising in a few instances, most responding Governments were of the persuasion that the greatest opportunities for expanded information exchanges could be found in greater utilization of bilateral or multilateral tax treaty provisions. In particular, it appears that developing countries, which currently receive a relatively small amount of the total information exchanged, would favour more extensive agreements (possibly multilateral) at least with respect to information exchange.

Specifically, an expansion of the types of information exchanged on a routine or automatic basis was deemed desirable. Most current automatic exchanges cover only investment income (dividends, interest and royalties) and income for services received by residents of treaty countries. Such exchanges could be expanded to include information concerning a variety of transactions in which taxpayers of each country engage in the other country.
Furthermore, where fiscal evasion is suspected, one developed country proposed that:

(a) The provisions of existing treaties be amended or reinterpreted to authorize the disclosure of necessary information to the treaty partner;

(b) Administrative procedures be established on a formal or informal basis to make such information available;

(c) When required, such information should be available in a form that would make it admissible in legal proceedings.

By contrast, other developed and developing countries stated that only routine information could be made available, due to the current burdens on their tax administrations. Those responding Governments which did indicate a desire to exchange greater quantities of specific information were, in general, of the view that availability of reciprocity would be sufficient compensation for such exchanges. A few developing countries felt, however, that in view of the overburdened tax administration, the treaty partner requesting information should bear any costs associated with securing it.

Some responding countries advocated a global view of reciprocity. It was argued that use of a global system would mean that the benefits gained by those who exchanged information would tend to equal out. Thus, there would be no need to insist on strict bilateral reciprocity. In any event, it was thought that such agreement should recognize the problems and needs of the developing countries and provide a preference for them.

In conclusion, two more suggestions of importance should be mentioned. Some countries advocated that the tax administration of each country establish a unit to centralize information needed by other countries and carry out requested assistance, including the conduct of investigations. Additionally, other countries supported the establishment of a permanent international panel of Tax Experts on Tax Treaties, which would, among other things, make practical proposals for carrying out increased information exchanges.
V. SUMMARY OF COUNTRY RESPONSES ON INTERNATIONAL INCOME-TAX EVASION AND AVOIDANCE

Representative countries responding to the questionnaire on international income tax evasion and avoidance, whose answers are used in this summary, are: Australia, Austria, Belgium, Burundi, Ceylon, Denmark, Fiji, France, India, Ireland, Israel, Japan, Luxembourg, Madagascar, Netherlands, Niger, Nigeria, Pakistan, Philippines, Switzerland, Tunisia, Turkey, the United Kingdom of Great Britain and Northern Ireland, and Zambia.

A. Extent and nature of international tax evasion or avoidance

No responding Government has available statistics concerning the extent of revenue loss resulting from international tax evasion. Ireland, the Netherlands, Turkey and the United Kingdom do not view their incurred losses from tax evasion as extensive; thus, they do not constitute a major problem. Burundi, Denmark and Japan consider that, due to the efficiency of the tax administrations and certain controls, such as the Foreign Exchange Control Act in Japan, evasion on the international level is not extensive. By contrast, India, Israel and the Philippines consider such losses to be significant. For instance, India estimates foreign exchange leakage due to under-invoicing and over-invoicing at from 500 million to 700 million Rupees per annum. The Philippines estimates its untaxed-funds outflow as possibly exceeding $US100 million per annum. In Ceylon, the value of gems smuggled (and therefore presumed not to be returned for income tax) is estimated at 350 million Ceylon Rupees per annum. The other respondents acknowledge problems of varying significance, which often consist only in a belief that evasion or avoidance is actually occurring.

Predominant patterns of international tax evasion may be segregated into four categories: undisclosed foreign-source income; income reallocation; holding companies; and bearer shares. Further, tax avoidance or evasion from income reallocation to lower tax areas (due to failure to deal with affiliates at arm’s length) may be separated into: management fees; transfer pricing; royalties; and intercompany loans. Problems of bearer shares are mentioned by only a small number of respondents.

SPECIFIC RESPONSES

Belgium

The use of the foreign holding company to reap benefits from the exceptional tax régimes of certain countries is considered by Belgium to be a problem. In particular, the complaint centres about a failure of those companies properly to report royalties, interest and personal service income. Mentioned also are sales of stocks and bonds for which the value received did not correspond to that given, which might produce no taxable income or taxable income in the favourable régime.

Further, Belgium refers to the failure of some firms to deal at arm’s length with enterprises with which they have close links or common interests. This failure includes low prices for sales and high prices for purchase, as well as abnormal rates on rents, commissions, refunds and even penalties. The most important area of evasion, however, is believed to be the use of portfolio investment and banking abroad in order to avoid Belgian taxes. Additionally, a matter of concern is investment in foreign real estate to conceal that type of earnings.

Burundi

Burundi states that its major problem concerns the quantity and prices listed on invoices from parent enterprises and purchasing agencies located abroad. Without administrative assistance in the form of information exchanges with other countries, the extent of this type of evasion cannot be evaluated.

Ceylon

Ceylon reports that over-invoicing of imports and under-invoicing of exports, retention abroad of commissions and rebates, and excessive claims for deduction of foreign expenditure in relation to earnings in Ceylon are the main patterns. Undeclared income retained abroad is usually not invested in business enterprises, but is kept in Swiss banks or in foreign government securities, or, less often, in public commercial securities.

There is no recognized system for the issue of bearer shares in Ceylon, but use of nominees is not infrequent. On the other hand, undeclared foreign-source income does not appear to be a problem, except with certain journalists which are published abroad. The practice of foreign business houses routing imports to Ceylon through other affiliated enterprise abroad, in such a manner as to retain a larger margin of profit abroad, is not likewise infrequent. At a time when there was a moratorium on the remittance of profits abroad, the inflation of expenses for services rendered abroad in connexion with income earned in Ceylon would have been more frequent.

Denmark

The laws designed to prevent tax evasion or avoidance are well developed in Denmark. If tax evasion or avoid-
ance nevertheless occurs, the reasons are to be sought in
domestic administrative factors coupled with the fact
that some countries offer their citizens a very high degree
of protection. The exchange of information provided for
under bilateral agreements for avoidance of double tax-
tion is of great help in the exercise of control of the
information furnished by taxpayers and in confirming
suspected practices of tax evasion or avoidance.

France

The predominant patterns of international income-tax
avoidance or evasion vary greatly. The practices listed
in paragraph 1 of the questionnaire are employed most
often and undoubtedly represent an important part of
the deliberate fiscal evasion. The dividends and interest
can be easily collected in an anonymous fashion in a
financial establishment in a third country, where the
stocks and bonds are deposited. This category of revenue
lends itself also to varied fraudulent practices taking
advantage of certain provisions of internal legislations
(regulations of investment funds of the holding companies
etc.). This form of evasion favours accumulation of
capital in the country where the fiscal demands are
smallest. It may permit the taxpayers to escape, in the
country of domicile, the tax on the property acquired by
means of accumulation of capital. Fiscal evasion also
currently occurs through the practices described in para-
graphs 4 and 5.

It is often difficult to reach revenue from foreign
sources when its remittance is effected abroad because
the necessary information can only be obtained from the
tax administration of the country of source. For this
reason, French administration is often not in a position
to verify the correctness of the deductions of expenses
incurred abroad for the acquisition or maintenance of
income—expenses which are normally recognized in
France as deductible expenses.

The means of review and the power of investigation
that the administration has pursuant to domestic legis-
lation are exercised exclusively within France and there-
fore prove completely inoperative to secure an effective
review of the tax due with respect to foreign income and
property.

The administrative assistance in fiscal matters organized
among States helps, in principle, to remedy this situation.
In effect, however, its operation is generally difficult,
which considerably restricts its effectiveness. Adminis-
trative assistance is further limited by strict application
of the clauses of reciprocity and of clauses concerning
secrecy.

India

India reports that all the types of tax evasion mentioned
in the questionnaire are occurring. In fact, several actual
cases have recently come to light as a result of searches
by various enforcement agencies, including the Income
Tax Department. Steps taken to prevent such practices
have so far been mostly administrative—strengthening
the enforcement agencies and providing them with wider
powers.

With respect to types of techniques of evasion/avoid-
ance listed in the questionnaire, India reports as follows:

(a) Non-declaration of foreign-source income, such as
interest and dividends, by residents is not a primary
method of evasion, but is a by-product of other types of
evasion resulting in secretion of moneys outside India
which are invested abroad without being disclosed;

(b) Under-invoicing of exports and over-invoicing of
imports, and payment of “bogus” commissions etc.
abroad are the common forms of evasion of tax and
result in understatement of profits of businesses that are
primarily India-based. No data are available for gauging
the extent of evasion by residents through non-disclosure
of foreign-source business profits. As a rule, the motive
for such evasion is a desire to secrete funds outside India
in violation of the restrictions on foreign exchange;

(c) Evasion of tax by residents not declaring foreign-
source wages, salaries and other earned income is not
likely to be a major source of revenue loss, particularly
in view of the tax concessions available in respect of such
income. However, receiving secret commissions on pur-
cesses of plant, machinery, components, spares and raw
materials appears to have become a widespread mode
of secreting foreign exchange and evading taxes in the
context of the rapid industrialization of the country and
its numerous development plans involving the large-scale
importation of such items;

(d) Overstatement of foreign expenses by non-residents
operating in India and excessive allocation of foreign-
based head-office expenses against Indian-branch profits
are also common forms of tax evasion. In addition, over-
statement of foreign expenses by Indian concerns is
fairly common. It is difficult to check such types of
evasion in the absence of adequate machinery for obtaining
authoritative information from abroad;

(e) Transactions resulting in tax avoidance between
foreign holding companies and their Indian subsidiaries
are common. Similarly, avoidance by suppressing the
relationship of agent and principal between a resident
and non-resident under the legal cloak of acting on a
principal-to-principal basis would appear to be widely
prevalent;

(f) No “bearer shares” or “bearer bonds” are
issued in India;

(g) Investment of funds secreted outside India by resi-
dents breed further tax evasion. Bearer shares might well
be a convenient medium for such secret investments
abroad in countries where facilities for such investment
exist.

Iran

Iran states that it believes that all the types of tax
evasion mentioned in the questionnaire, except the use
of holding companies, are occurring; but it has no proof.

Israel

In Israel, the fundamental problem arising out of tax
evasion or avoidance is the illegal transfer abroad of
undeclared and untaxed income. It is fair to assume that
the sums transferred abroad also produced income—both
revenue and capital—and this income is likewise unde-
clared and untaxed. It is also possible that ways are
found to invest these funds in Israel as if they were genuine investments by non-residents in foreign currency and thus to “rehabilitate” them so as to take advantage of the tax benefits and reliefs granted in respect of such investments.

Of the various methods of tax evasion listed, Nos. 1, 2, 4 and 5 are regarded as especially serious. Efforts to deal with the problem of tax evasion and avoidance have been seriously hindered by the “secrecy” provisions in the very countries to which these funds have been illegally transferred.

The Israel Income-Tax Ordinance contains a number of provisions designed to prevent tax evasion or avoidance: section 4, in connexion with costs and prices abroad in the case of foreign trade; section 30, under which the Commissioner is empowered not to allow expenses which, in his opinion, exceed those required to produce the declared income; section 85, in respect of revokable dispositions; section 86, with respect to artificial or fictitious transactions; section 111, in connexion with transactions between residents and non-residents; section 130, which empowers the Commissioner to order that certain categories of assesses must keep proper accounts as prescribed by him; section 140, in connexion with demanding information from official and public bodies; and the various sanctions and penalties provided for in the Ordinance. There is, in addition, a law for the exchange of information between revenue authorities.

**Japan**

It is generally thought that controls, efficient administration and close scrutiny of taxpayer’s returns in Japan have eliminated most evasion of the types listed. For example, foreign-source interest and dividends (including bearer shares) are difficult to earn without declaration, due to the fact that declarations must first be made in order to make the investment abroad. Information collected by the tax authorities, combined with that exchanged with other countries under double-taxation agreements, is believed to cause taxpayers to file proper returns in the area of foreign business profits. Special guidance is conducted, at the firm level, to make sure that foreign employees, resident in Japan, declare income earned in their home countries. Although overstatement of expenses incurred abroad may take place, and information is difficult to obtain, specific justification is requested when the return is thought to be suspect. Transactions between related enterprises are checked by inquiring into the prices of similar transactions, the market situation etc. Although foreign holding companies are not unusual, investment in them is regulated by the competent authority and not permitted unless its objective is justifiable.

**Luxembourg**

Luxembourg reports that the most prevalent types are undeclared foreign-source income in the forms of interest, dividends and royalties, and the use of unrealistic prices by non-residents doing business in Luxembourg. It has, however, eliminated evasion of tax by non-residents purchasing bearer shares issued in Luxembourg by requiring a withholding of 15 per cent at the source. Luxembourg feels that its efforts to prevent evasion have not been hindered by foreign legislation or administrations.

**Madagascar**

Madagascar reports that there is unrealistic pricing among affiliates and that there is a problem with the undeclared foreign-source income of its residents, especially in the absence of exchange of information. It also mentions that the ease of movement of bearer shares within the same monetary zone prevents effective control.

**Netherlands**

The Netherlands is satisfied that tax evasion is not of major importance under its prevailing control system which, *inter alia*, makes use of data obtained by implementing the capital tax and which has promoted fiscal discipline. Constant attention is paid to the phenomenon of tax evasion, particularly with respect to points 1, 6 and 8, which are the most likely forms of evasion.

**Niger**

Although it does not know which is the most important type of international tax evasion, the Niger is of the opinion that some foreign-source income, including interest, dividends, salaries and wages and business profits, is going undeclared.

**Nigeria**

The patterns of concern to Nigeria are overstatement of expenses for services rendered to foreign-controlled Nigerian enterprises, including payments for non-resident technicians and experts not affiliated with such enterprises. Of concern also is unrealistic dealing between parent firms and their affiliates, especially with respect to purchase and sale of goods, royalty payments, interest and management fees, which is done primarily to evade Nigerian regulations concerning remission abroad of profits.

There is also some use of holding companies or agents abroad to receive income directly or indirectly accruing to residents from foreign sources. These practices have been discovered in the course of examination of taxpayers’ accounts and investigations. Nigeria has not experienced any difficulty with foreign legislation or administrations.

**Pakistan**

Pakistan reports that there has been collusion in invoicing on some imports of plant and machinery between the taxpayer and the foreign supplier. In some cases, an intermediary, resident in a capital-exporting country, but controlled by a Pakistan importer, has been used. The types of evasion known to be widely practised are:

(a) Foreign investment income of Pakistan residents who have temporarily lived abroad. The extent of evasion on this score may not be large;

(b) Income from investment in foreign countries made through normal banking channels has to be reported to the Central Bank; but, income from investments financed
through transfer out of the country of untaxed Pakistan rupees is not reported;

(c) There appears to be no evasion in the area of undeclared foreign-source earned income. If such evasion exists, it is negligible;

(d) Foreign technicians employed by Pakistan enterprises are exempt from tax for a period of from three to five years. Such an enterprise, therefore, tends to overstate the salary of the technician, thereby reducing its own taxable income. Where foreign-owned enterprises are concerned, the tendency is to overstate the head-office expenses for services rendered and salaries to directors paid abroad, such salaries not being taxable locally;

(e) Foreign enterprises operating in Pakistan through subsidiaries are reported to have sold semi-processed goods to their subsidiaries in Pakistan at 1,000 times the normal price. Had the normal price been charged, the Pakistan subsidiary would have reported higher taxable income;

(f) Pakistan exporters selling goods in foreign markets often do so on a commission basis through their agents abroad. There is a strong tendency to overstate the commission thus payable to the agents;

(g) Transactions (locally known as “blank transfer”) in registered shares do take place in which the owner can conceal his identity, but there is no information of non-residents participating in such transactions.

Amnesty for disclosing foreign exchange illegally held abroad was declared in the country in 1958 and 1969. On both occasions, substantial holdings of foreign exchange abroad were disclosed, which is sufficient proof of the existence of the aforementioned practices, at least in so far as residents were concerned. Different governmental agencies have, from time to time, tried to grapple with the problem, but thus far with insignificant success.

**Philippines**

In the Philippines, international tax evasion consists of:

(a) Undeclared foreign-source interest, dividend, rental or royalty income accruing to residents;

(b) Undeclared foreign-source wages, salaries and other earned income accruing to residents;

(c) Overstatement by enterprises doing business in the Philippines of expenses for services rendered within the country to such taxpayers by non-resident technicians and experts not affiliated with such taxpayers;

(d) Unrealistic prices reported by non-resident taxpayers doing business in the Philippines, as well as domestic businesses doing business abroad, relating to transactions with affiliates;

(e) Use of bearer shares issued abroad.

Mentioned also are royalty payments disguised as service charges, inclusion of interest in purchase prices and over-declaration of exports on fictitious declarations and valuations in certain goods.

In addition, over-declaration of exports or fictitious declarations are resorted to be embroidery and apparel contractors. Under the Philippine law, raw materials received from foreign consignors to be manufactured into wearing apparel are tax-exempt. To make huge profits, these raw materials are canalized or sold in the local market, and fictitious export entries are entered in their books of accounts.

Underpricing of logs and oil exports are resorted to principally to avoid foreign exchange control, but also to avoid income tax.

**Switzerland**

Tax evasion often occurs in Switzerland when the taxpayer believes that his payments are excessive or not accomplishing their purpose, or that he is being treated unfairly, or when a disagreement has arisen between the taxpayer and the tax authorities. Gaps in the laws and inefficient administration of the laws also contribute to the problem. A moderate level of taxation and fair legislation coupled with an effective and efficient tax administration, as well as proper use of public funds, are and will remain the surest measures in the fight against international income-tax evasion.

The principal source of tax information is the taxpayer himself and, in keeping with the concern of the Swiss law about the traditional liberties of the citizen, the power of inquiry on the part of the tax authorities is limited. The examples cited in the questionnaire are both cases of tax fraud per se and cases where there may merely be a disagreement between the tax authorities and the taxpayer. Residents are more inclined to report their foreign dividends and interests when, pursuant to a double-taxation convention, they are entitled to reimbursement of the reduction of the source tax in the country of the source of income. Swiss residents have no interest in failing to declare their business profits from a permanent establishment abroad when even under the domestic law they are exempt from tax, subject only to the calculation of a higher tax on other income. Employers resident in Switzerland are required to report salaries and remunerations received by their employees. Appropriate corrections are made if it appears that manipulations, such as those described under points 4 and 5, are practised. If property is transferred to a Swiss citizen or a foreigner (holding, trust) solely for the purpose of evading the tax, the Swiss authorities can continue to tax such property and revenue therefrom, as if the transfer did not take place.

**Tunisia**

With respect to foreign income of residents, the principle of the territoriality of the tax and of the law in general, coupled with absence of administrative assistance, permits fiscal evasion in Tunisia. A frequently occurring case is that of an establishment or a subsidiary of a foreign enterprise receiving raw materials from abroad and producing a semi-finished product with Tunisian labour and energy, which is taxed on the value added on a presumptive basis and does not fully reach the real profit. As concerns domestic income of non-residents, the problem centres on the expenses of the headquarters of the foreign enterprise. In the absence of
the administrative assistance between tax administrations, it is impossible to verify the true expenses, and a presumptive figure on the turnover not exceeding 10 per cent is applied.

**United Kingdom of Great Britain and Northern Ireland**

In the United Kingdom, it is difficult to discern general patterns in the practices of international tax evasion. In those cases where opportunities for evasion may exist, the United Kingdom has tried to remove them. To this end, provision is made in the income-tax law to deal with sales at unrealistic prices between associated persons. The law provides that for tax purposes an arm's length price may be substituted. There is likewise legislation to cover the case of holding companies, these being nominees which exist for the purpose of holding securities on behalf of the real owner. To prevent this arrangement from giving dishonest taxpayers an opportunity to conceal some of their income, the revenue authorities are empowered to require nominees to declare on whose behalf income from United Kingdom securities has been received. These powers also extend to bearer shares.

**Zambia**

Zambia believes that evasion has been occurring in the area of management charges, consultant fees, unrealistic purchase prices motivated by a desire to remit funds abroad to avoid exchange control regulations and undeclared interest and dividends.

**B. International co-operation through exchange of information**

**Specific responses**

**Austria**

Austria has six double-taxation agreements providing for the routine exchange of information concerning dividends, royalties, interest, rents and salaries. In addition, 14 of its conventions provide for exchange of information upon specific request.

Some Austrian treaties provide for a reduced rate of dividends tax in Austria, and the tax is deducted at the full rate at the source and the reduction given by way of repayment. Such repayment is given upon a special claim in which the tax authority of residence has to confirm that the taxpayer is a resident and subject to tax there.

**Belgium**

Belgium reports that its efforts to fight international tax evasion have been frustrated by banking secrecy, privileged status of holding companies in some countries (tax havens), bearer shares and failure of numerous countries to take a withholding tax or otherwise control foreign stock cashed in by non-residents; and, lastly, by the absence of any regular systematic exchange of information between interested countries. Belgium has not organized any general and routine exchanges through its double-taxation agreements, except in the cases of dividends, interest and royalties where a credit or exemption is claimed by the taxpayer. Specific requests are honored, but they are used only slightly and are mainly in the area of allocation of profits between business units. There is also a regular exchange with treaty partners of legislative and administrative documents.

**Burundi**

Burundi has no accords or other arrangements for the exchange of information.

**Ceylon**

In Ceylon, there are no agreements outside the double-taxation agreements with seven countries which provide for exchange of information for the purpose, among others, of preventing fraud. Ceylon has no agreements providing for the exchange of information in relation to the collection of taxes. There are no routine exchanges of taxpayer information, nor have specific requests been received. Copies of taxing acts are sent to interested countries as a matter of course.

**Denmark**

Denmark has entered into bilateral agreements with 22 countries for exchanges, upon request or on a routine basis, of information (which is accessible to the competent authorities under the tax laws of the countries concerned) necessary for enforcement of the taxes covered by such agreements.

With three countries (Finland, Norway and Sweden), Denmark has entered into special agreements on assistance in matters relating to taxation, including an obligation to exchange information on a routine basis. Routine exchanges, primarily about dividends and salaries, are made with 19 countries.

**Fiji**

Fiji has several double-taxation agreements which provide for the exchange of information for the prevention of fraud or for the administration of statutory provisions against tax avoidance and go beyond the terms of the OECD Model Convention (e.g., Switzerland). The only routine exchange is with the United Kingdom, concerning interest. Specific requests (less than 10 per annum) have been received from the United Kingdom, relating to interest and dividends. Legislation and administrative regulations and guides are also exchanged with other countries.

**France**

France has conventions with 12 countries, including six developing countries of French expression in Africa, which cover routine exchange of information concerning income of all nature of individual legal entities. In addition, it has agreements with a few countries in which the routine exchange of information is limited to certain categories of income or persons. France has agreements with 13 countries concerning routine information with respect to death duties and droits d'enregistrement only. Exchange of information on request is undertaken with respect to 25 countries. With respect to 13 countries,
routine exchange of information has not yet been defined and organized, and only exchange of information on demand has taken place. As a general rule, the exchange of information on demand facilitates verification of the amount and value of elements whose existence is already known to the requesting administration: interest from bank accounts; true level of royalties; and division of profits between parent and its affiliates.

**India**

The agreements that India has with other countries are mostly double-taxation conventions. The clauses in these agreements relating to exchange of information are confined to such information as is necessary for implementation of the convention. India has no agreements with other countries for exchange of information aiding in enforcement of income taxes and other taxes. There are no provisions in any of the agreements with other countries for taxpayer information exchanged upon specific request. In fact, attempts to secure such information through normal channels have been unsuccessful. Exchange of information relating to tax laws takes place on an informal basis with most of the European and Asian countries, the United States of America and Commonwealth countries. Considerable assistance in securing authoritative information relating to foreign tax laws is also received from the various embassies and standard publications in the different countries. Study teams have also helped in exchange of such information.

**Ireland**

Ireland has no agreements or arrangements for the exchange of information aiding in the enforcement of income or other taxes. There is an article in each double-taxation agreement (excluding that with Switzerland) for the exchange of such information as is necessary for the carrying-out of the provisions of the agreement. This article usually follows the OECD Model Convention or the agreement of Ireland with the United States of America (1949).

**Israel**

The only agreements and arrangements to which Israel is a party are those included in the framework of the various conventions for the avoidance of double taxation signed by it. These arrangements are limited in scope and rarely put into effect.

**Iran**

In Iran, the most recent double-taxation agreements are designed to contain a provision for the exchange of information; but only an agreement with the Federal Republic of Germany is currently in force. Other necessary information is obtained from the International Bureau of Tax Documentation at Amsterdam.

**Japan**

Japan has 22 arrangements for the exchange of information concerning income, and it carries on routine exchange. Japan gave information on about 18,000 items to 13 countries from January 1969 to April 1971, and received information on about 5,500 items from three countries in the same period. The types of information exchanged, in the order of frequency, are as follows:

(a) **Information given:** dividends; remunerations; rentals of immovable property; interest on loans; royalties; salaries;

(b) **Information received:** interest on loans; rentals of immovable property; remunerations; royalties; dividends; scholarships.

Each of the arrangements also provides for exchange of information upon request; but such exchanges have not been frequent. Information most frequently received has been with respect to business activities carried on abroad by domestic enterprises.

**Luxembourg**

Luxembourg has signed six agreements for the elimination of double taxation. Each contains provisions for the exchange of information. Four are, however, limited to the information necessary to carry out the convention. There is a provision with its Benelux partners for the exchange of information relating to all taxes. Furthermore, treaties with the United Kingdom and the United States of America provide for the routine exchange of information. Under these treaties, information has been received (interest, dividends, royalties); but none has as yet been given. No specific requests have been received.

**Madagascar**

Madagascar has arrangements for the exchange of information with France and a multilateral agreement with the Organisation Commune Africaine, Malgache et Mauricienne (OCAM). Information relating to interest and salaries has been exchanged with France. In the absence of a treaty, information can only be exchanged upon specific request.

**Netherlands**

The Netherlands has 12 double-taxation agreements with respect to income tax, which provide for the exchange of information; but only that with France is on a routine basis. There are also a few agreements with respect to death duties and other taxes. The information covered by the routine exchange includes data on registration of business enterprises, marriage settlements, immovable property, debts secured by mortgages and apportionment of profits. The information most frequently exchanged on specific request is related to expenses or deductions claimed (technical "know-how", management fees) and divided between affiliates.

**Niger**

The Niger has treaties with France and several of the French-speaking countries of West Africa, and the agreement on fiscal co-operation of OCAM (1971). Routine exchanges with France are carried on concerning salaries, dividends, rents, turnover, etc. Exchange of information upon specific request is carried on with neighbouring countries despite the absence of a treaty providing for it.
Nigeria

In Nigeria, formal exchange of information is limited to the double-taxation agreements and primarily covers the area of tax relief, rather than enforcement of income and/or other taxes. Informal exchanges, in the form of correspondence, have been carried on with the United Kingdom.

Pakistan

Pakistan states that all eight of its conventions for the elimination of double taxation (excluding that with Switzerland) provide for the exchange of information. There is a routine exchange with the United Kingdom and the United States of America, primarily in the area of interest and dividends. Treaties with Japan, Sweden, the United Kingdom and the United States of America provide for the exchange of such information in the normal course of administration as is necessary for carrying out the provisions of the treaties. The treaties with Ceylon, Denmark, the Federal Republic of Germany and France provide for the exchange of information upon request.

Philippines

The Philippines has four tax treaties, all providing for the exchange of information, only one of which has been ratified. In addition, a few instances of information obtained through diplomatic channels are reported. It freely gives tax statutes and regulations to requesting countries.

Switzerland

Switzerland has 16 conventions for the elimination of double taxation. Three treaties (France, United Kingdom and United States of America) have a provision for the exchange of information necessary to carry out the convention. The treaty with the United States of America also has a clause for exchange in cases where there is tax fraud. The Swiss position is that these clauses for exchange of information are superfluous, the application of the substantive provisions of the convention itself necessarily having to include exchange of information in order to be carried out. Switzerland entered an express reservation to article 26 of the OECD Draft Convention of 1963.

Tunisia

By applying withholding of the tax at source to the debtor of the revenue, the evasion is considerably limited in this field as concerns Tunisia. With respect to foreign income, the exchange control applicable in Tunisia obliges the resident to repatriate income from foreign activities; nevertheless, this control is difficult to apply. Only the double-taxation agreement with Sweden provides for the exchange of information. This agreement, however, has not resulted in any exchanges of the kind that would counter international tax evasion.

United Kingdom of Great Britain and Northern Ireland

All comprehensive agreements to which the United Kingdom is a partner have a clause relating to the exchange of information. The information so exchanged must, on the part of the United Kingdom, be that which is available under the law to the Inland Revenue in the normal course of administration, being information necessary for the carrying-out of the provisions of this agreement and preventing fraud or the legal avoidance of the taxes covered by it. Routine information is sent to almost all treaty partners. The kinds of information transmitted include:

(a) Duplicates of claim to repayment of tax made by oversea residents;
(b) Details of oversea residents receiving United Kingdom income relieved from United Kingdom tax at source;
(c) Details of interest received in the United Kingdom by oversea residents;
(d) Details of fees and commissions paid to oversea entertainers;
(e) Details of oversea residents who have claimed exemption from tax.

In return, the United Kingdom receives from abroad a quantity of similar information, which is then distributed from a central point to one of the local tax-offices throughout the country, where it can be linked with the individual taxpayer's file.

The article concerning exchange of information would be deemed to cover individual cases in which taxpayer information is exchanged upon specific request. While the United Kingdom does, from time to time, take advantage of that article, no record is kept of the numbers involved or the nature of the inquiries made; nor is there any record of the number of inquiries received.

The Inland Revenue finds it most useful to maintain a store of information about the tax system of other countries. For that reason, it welcomes any information sent to it, irrespective of whether this is done under the terms of a double-taxation agreement. The United Kingdom is also pleased to supply similar information on a reciprocal basis; information is currently so exchanged with some 50 countries. These exchanges are not bound to the provisions of a double-taxation agreement. Under a number of agreements, however, changes in taxation laws are to be formally notified by the competent authorities. Apart from the cases listed above, exchanges of information are conducted under informal arrangements between the Inland Revenue and the revenue authorities or finance ministry of the oversea country concerned. Under these exchanges, the United Kingdom Inland Revenue receives and distributes published literature of the following kinds: texts of statutes; copies of double-taxation agreements; tax guides prepared for the public; official tax periodicals; and annual revenue reports and statistics. The Inland Revenue neither distributes nor expects to receive unpublished documents dealing with legislation, departmental regulations and judicial or administrative decisions.

Zambia

Zambia does have arrangements through its double-taxation agreements. Routine exchanges are confined to interest and dividends only with South Africa and the United Kingdom. Other exchanges are made when needed.
**Future steps to promote information exchanges**

**Austria**

At the current time, Austria does not envisage any steps to promote information exchanges.

**Belgium**

Belgium plans to implement the current provisions in its double-taxation agreements and to set up a regular programme of routine exchanges within that framework. It also wishes to expand that network and will try to include in them provisions for routine information exchange. Belgium places an emphasis on reciprocity and will not exchange information of a type it cannot have in return. This restriction, however, does not extend to quantities of information. Belgium states also that it cannot evaluate the result of routine exchange because of inadequate experience. Nevertheless, there are provisions for banking secrecy with respect to personal income unless a non-resident claims a Belgium tax reduction. Thus, there might be information available to exchange. Lastly, Belgium believes that any matter that concerns the determination of corporate profits and allocation between affiliates should be handled through specific requests.

**Burundi**

Although international income-tax evasion is not a major problem in Burundi, information exchanges are considered desirable as long as they are conducted through official conventions. It hopes for reciprocal exchanges although it will furnish information requested even if it is not strictly available in the requesting country. Because of the expense involved, it would prefer that requests be made only when a strong case of tax evasion is presumed.

**Ceylon**

Ceylon believes that exchange would be very beneficial; but, due to the secrecy provisions in its income-tax law, any exchange would have to be through formal agreements. The exact scope and nature of the exchange would be a matter for general discussion among countries with similar problems. Although a substantial degree of reciprocity is desirable, a lack of such reciprocity need not be considered an impediment to the conclusion of an agreement. It is preferred that the exchange be made on a routine basis and also, of course, in response to specific requests. While Ceylon desires to have as many agreements as possible, it would not be willing at the current time to make monetary compensation for costs incurred in the supply of such information in view of the other demands on the fund of foreign exchange available to it.

**Denmark**

Denmark seeks to have tax agreements provide for the exchange of such information as is necessary for enforcement of taxes under national laws. Formal agreements are insisted upon because of its national law and on reciprocity for rendering assistance (although Denmark has not attached decisive importance to it in practice).

**Fiji**

Unless Fiji becomes a retirement area for wealthy persons from overseas, it is not considered that information other than foreign-source income from interest, royalties, rents and dividends accruing to residents and information relating to expenses should be sought. No plans have been formulated to exchange information. Fiji would welcome information on management charges of groups of foreign enterprises where substantial sums are charged to Fiji branches or subsidiaries and investments made by residents in oversea countries.

**France**

France sees a need for a more precise and extensive definition in the conventions of the assistance that is to be rendered between the concerned administrations. The procedures for exchanging information should be simplified and routinized. These improvements would necessarily imply the availability of information to exchange and direct access to sources of information. It recommends that each administration be as efficient as possible. On the practical level, the scope of the routine assistance should be enlarged and expanded systematically to all information collected by the administration. Furthermore, it is necessary to ensure a collaboration between tax administrations and exchange of information concerning their investigative procedures in order to discover the principal methods of fraud and the means for their detection. The expansion of the scope of the fiscal assistance would require establishment of a body by each State or a unit equipped with necessary powers to render assistance to other administrations. Such service should centralize documentation to be transmitted to other Governments and undertake inquiries and investigations required by the requests coming from other States. The effectiveness of the organization could be reinforced by a permanent representative accredited by each collaborating administration, who could advise the tax administration to which he is accredited on the investigative facilities of the State he represents. Further, a global concept of reciprocity is needed, rather than the strictly bilateral approach. The advantages necessarily would arise from the totality of information available for exchange rather than from equal bilateral exchanges.

**India**

India sums up the steps it believes are necessary as follows:

(a) Exchange of information on the basis of formal agreements between countries;

(b) Enlargement of the scope of Indian domestic income-tax laws to authorize comprehensive bilateral tax treaties (the current law empowers only so far as avoidance of double taxation is concerned);

(c) Revision of old treaties and conclusion of new treaties under new legislation providing for exchange of information;

(d) Provision for the routine exchange of information along the lines of the agreement between France and the United States of America (1939);
(e) Exchange of information relating to tax laws and fiscal policies;
(f) Procurement of commercial intelligence;
(g) Expansion of agreements to all direct taxes, not just income tax;
(h) In the absence of comprehensive agreements, conclusion of limited agreements for exchange of information;
(i) Co-operation between developed and developing countries under the aegis of the United Nations to ensure that the benefit of exchange of information shall be shared by both;
(j) Setting-up of an international body or a panel of experts to deal with international tax evasion/avoidance; the body could also function to resolve differences in the interpretation or implementation of tax treaties;
(k) A provision similar to article 26 of the 1967 agreement between France and the United States of America, for mutual assistance in the investigation of specific cases of tax fraud.

Reciprocity has to be a necessary element of all such information exchanges. As concerns costs, where the exchange is mutual on a routine basis, it would be best if the contracting countries were to bear their own expenses. As concerns specific requests, a provision for monetary compensation for the costs incurred would put a healthy check on any tendency to call for unimportant or superfluous information.

Israel

The opinion of Israel is that not only should the Ad Hoc Expert Group examine the matter of information exchange, but an international panel of tax experts should be set up without delay in order to make practical proposals for setting up the machinery required for exchange of information.

With respect to exchange, Israel does not reject the concept of parity, but maintains reservations concerning the developing countries. Their economies are so dissimilar to the developed countries that the required conditions for the exchange of information on such a basis do not exist. Any arrangements made should give preference to the requirements of the developing countries. It should also be borne in mind that the developing countries are in need of a constant inflow of investment capital, and due consideration should therefore be given to the possible detrimental effect that the furnishment by them of information concerning foreign investors might have on this inflow. Thus, the current situation favours exchange on a specific, and not on a general routine, basis. It is doubtful whether the developing countries have had sufficient time to reach the level of administrative sophistication required to deal with a general flow of information. Proper weight should also be given to the possible effect of the setting-up of a general machinery for the routine exchange of information on the flow of non-governmental investment capital to the developing countries. Israel is prepared to meet the costs incurred by another country in providing Israel with information requested by it for income-tax purposes.

Japan

Exchange of information is carried out by Japan mainly under the provisions of double-taxation conventions, in consideration of the obligation of tax officials to keep the information secret. Exchange of information on a reciprocal basis will be stepped up commensurate with the expansion of double-taxation agreements. It might be useful to have mutual consultations between tax authorities with respect to the kind of useful information to be exchanged in general.

Luxembourg

Luxembourg will expand accords on exchange of information within the framework of double-taxation agreements. Substantial reciprocity is not viewed as an absolute necessity for exchange. It has no particular projects in mind in the area of information exchanges.

Madagascar

Madagascar considers it preferable to establish a convention (on a world or multilateral basis) to exchange information obtained by the tax authorities in one country and of interest to other countries. Reciprocity should not be taken into account in the matter of quantity of information since it is most often the nationals of developed countries who have investments in the developing countries. The measures taken by the latter countries are not as effective unless they are supplemented by regular assistance from the former countries.

Netherlands

Tax evasion being of minor proportion in the Netherlands, no particular measures are currently under consideration. Although a balanced reciprocity in the exchange of information is preferred, it is not in all circumstances deemed to be a necessary element where economic life in the countries concerned has not been developed to the same extent. The degree of reciprocity may depend upon the balance of the other provisions of the bilateral convention for the avoidance of double taxation. In any case, the restrictions on the exchange of information laid down in article 26, paragraph 2, of the OECD Draft Double Taxation Convention on Income and Capital are considered to be indispensable. In this connexion, it should be mentioned that the Netherlands is not prepared to exchange information received from banks or other financial institutions.

Under the provision laid down in the answers indicated above, the following points could be stated:

(a) New arrangements for the exchange of information will be made within the framework of the conclusion of double-taxation conventions, the number of which is constantly growing;

(b) It is thought that for the Netherlands, the scope of the exchange of information should not necessarily give rise to a compensation of costs incurred in supplying such information;

(c) The fact that the information requested is not in good order at the disposal of the tax administration is a serious obstacle to the compliance of the request;
(d) Exchange of information in response to specific requests is preferred.

Niger

The Niger is open to any means of official or unofficial exchange of information.

Pakistan

Pakistan would favour expansion of existing arrangements for exchange of information with treaty countries. Pakistan considers that it would not be in the interest of international co-operation if exchange of information were made upon monetary compensation being paid to the supplying country. It plans to emphasize, in its negotiation of double-taxation conventions, the importance of exchanges of information, especially with respect to administrative regulations on secrecy and the need to eliminate them. For exchange of information, it should be realized that the information needs between the developed and developing countries is asymmetrical: the former needing information about foreign-source income; the latter about expenses, services rendered and other transactions by taxpayers doing business within their countries. Thus, strict reciprocity should not be demanded. Because of the heavier burden, however, the granting of administrative assistance to other tax authorities should be on a reciprocal basis. In this connection, periodical mutual exchange of views between officials of the contracting countries would be of immense value.

Philippines

The Philippines plans both on more double-taxation agreements with exchange provisions and on the establishment of informal arrangements with others. It has been observed that there is a reluctance on the part of developed countries to provide broad exchange of information because of the unequal volume of information that can be secured from the developing countries. The Philippines would be willing to expand agreements for the receipt of information and to make monetary compensation for the costs in securing such information. Restrictive national law, like secrecy of bank accounts, might prevent the supplying of information. Since administrative machinery is inadequate in developing countries, response to specific requests would be acceptable, but over-all routine exchange of information is preferable.

Tunisia

It is believed that evasion could be largely eliminated by the establishment of a network of double-taxation agreements, including a clause for exchange of information, between Tunisia and the developed countries. The juridical borders of the fiscal system should be extended by means of an international administrative assistance. On the other hand, within the fiscal borders, all revenue realized within the territory should be effectively reached. The international organizations should promote the principle of complete exchange of information to combat fiscal evasion while safeguarding the principle of professional secrecy, but applied vis-à-vis third persons and not among tax administrations themselves.

Turkey

Turkey believes that all exchanges should be through formal agreements, and it approves the OECD Model Convention project.

United Kingdom of Great Britain and Northern Ireland

The United Kingdom is by law bound to secrecy in all matters affecting taxpayer's affairs. Information about these affairs can be supplied only if authorized by Parliament as part of the process of lending parliamentary approval to a double-taxation convention. In future, the United Kingdom would not invoke the principle of reciprocity against a treaty partner which made freely available the information at its disposal, even if the United Kingdom, under its general law, could offer a wider range of information in return. The United Kingdom is always amenable to the possibility of concluding new double-taxation agreements and considers the exchange of information to be an essential part of them, because of the mutual advantage flowing from such an arrangement. The sole limitation on the information exchanged is that the Inland Revenue can supply only what is available to it in the normal course of administration. The question whether such information should be exchanged on a routine basis or only in response to specific requests would depend upon the facts, and no general preference can be stated.

Zambia

A greater exchange of information would be beneficial to Zambia; but, in view of the limited number of foreign persons and residents in Zambia, it would be better to confine the exchange to tax agreements. The exchange could be routine for information on interest and dividends, and specific requests could be made on other matters. An increase of information is desirable; but it must be appreciated that, in common with many other countries, Zambia has an acute shortage of staff, which restricts the amount of information which can be given or dealt with. There could be obstacles to exchange of information with countries with which Zambia has no diplomatic contact.

International Co-operation in the Collection of Taxes

Austria

Austrian internal law prohibits the collection of taxes due in other countries. Three of its conventions, however, provide for rendering aid in collection (France, Federal Republic of Germany, Norway). It would be interested in expanding the reciprocal assistance in international income-tax collection where this is required by urgent practical need (which currently appears to occur only with relatively few countries).

Belgium

In Belgium, the collection of taxes owed to other countries would not be possible, but several of its double-taxation treaties were intended to further assistance in
collection of taxes mentioned in the agreements. Belgium is vitally interested in the extension of reciprocal collection assistance to the countries and tries to include such clauses in its treaties.

Burundi
Burundi has no agreements with respect to international co-operation in collection of taxes. It is interested, however, in the conclusion of assistance arrangements, formal or informal, with its neighbours, due to the number of its nationals having activities in them that might be subject to Burundi tax.

Ceylon
Ceylon has no measures for international co-operation with respect to collection of taxes. It would be interested in a scheme of reciprocal assistance with other countries in the collection of income tax. The exact scope and nature of this exchange would be a matter for general discussion among developing countries having problems of foreign exchange.

Denmark
Denmark has entered into agreements with 10 countries for assistance in collection of taxes. Collection by Denmark of taxes due to other countries can only be carried out in conformity with Danish law. Assistance can be requested only with respect to taxes covered by the relevant agreements, and a country can only request assistance if its own possibilities of collection are inadequate. The existing agreements have worked satisfactorily, and it is intended to incorporate provisions for such assistance in future agreements where needs for such co-operation exist or are foreseen.

France
In France, there can be no collection of taxes due to another State without the authorization of a formal international agreement. Provision for assistance in the collection of tax is made in several of its double-taxation agreements, such as that with the United States of America. France is favourable to an expansion of its agreements in the area of assistance in the collection of tax.

India
There are no provisions in the Indian Income-tax Act to aid collection of income taxes due to other countries. There are currently no agreements with other countries for giving or receiving assistance in the matter of collection of taxes due. The only provision in the Indian Income-tax Act that aids collection of income taxes due to other countries is in respect of recovery of Indian tax. These measures for checking avoidance and evasion would be frustrated by the absence of adequate arrangements for the recovery of tax due from the evader out of his secreted wealth abroad. The bilateral treaties should provide for mutual assistance in the matter of collection of tax. As concerns cases involving tax evasion at international level, where assets are built up in developed countries at the cost of developing countries, there is a moral obligation on the part of the developed countries to assist the developing countries in recovering the evaded taxes.

Israel
No measures have been taken in Israel with respect to the collection by other countries of tax due to Israel, or to the collection in Israel of tax due to other countries. As concerns developing or expanding programmes of reciprocal assistance in the collection of income taxes, Israel is of the opinion that this is a matter which could usefully be discussed by an international panel of tax experts.

Japan
There is no provision in Japanese domestic law for giving assistance in the collection of taxes. Several of the double-taxation conventions do have provisions for co-operation in this area. This co-operation is limited, however, to such cases as will ensure that exemptions, reduced rates of tax or any other benefits granted under the convention shall not be enjoyed by persons not entitled to such benefits.

Luxembourg
Luxembourg expresses little interest in concluding agreements for the collection of taxes, but will consider a clause including it within its double-taxation agreements if it is necessary to bring about the agreement.

Madagascar
Although Madagascar cannot assure the collection of taxes due to other countries having an assistance agreement with it, it is interested in developing a reciprocal programme of assistance for recovery of taxes.

Netherlands
In the Netherlands, measures to aid in collection of income taxes due to other countries are based solely on the conventions for the avoidance of double taxation with six countries and a special Benelux Convention.

Niger
Although it is not specifically provided for in its convention, the Niger states that mutual assistance is possible under the current conventions. It is interested in development and expansion of a reciprocal assistance programme, especially with its neighbours in West Africa.

Nigeria
There are currently no specific arrangements in Nigeria to aid in collection of income taxes due to any foreign country, nor does any country currently help in collecting any income tax due to Nigeria. Nigeria is interested in developing programmes of reciprocal assistance with other countries in the collection of income taxes, especially with respect to income taxes payable by residents of Nigeria who own properties and other resources of income abroad.
Pakistan

None of the treaties concluded by Pakistan provides for the collection of taxes of the other country. Although provision for reciprocal collection of tax with India exists in Pakistan law, it has not been used.

United Kingdom of Great Britain and Northern Ireland

There are statutory regulations in force by which the United Kingdom has undertaken to collect tax in certain circumstances on behalf of the following countries:

(a) Netherlands. Under the double-taxation agreement, United Kingdom residents who are subject to United Kingdom tax on dividends paid by a Netherlands firm are not liable to Netherlands dividend tax. The regulations provide that where Netherlands tax was not deducted and repayment of United Kingdom tax was subsequently claimed on the ground that the owner of the dividend was not a resident of the United Kingdom, the Inland Revenue will withhold from the repayment an amount equal to the Netherlands dividend tax. This amount will then be paid to the Netherlands tax authorities;

(b) Sweden. Similar arrangements have been made in the case of dividends paid by Swedish firms to residents of the United Kingdom. Under the terms of the double-taxation agreement, such dividends are exempt from Swedish coupon tax if they are subject to tax in the United Kingdom;

(c) United States of America. Under the double-taxation agreement, dividends paid to United Kingdom residents by withholding agents in the United States of America, are subject to a deduction of only 15 per cent. The regulations provide that if the United Kingdom tax deducted from such dividends is later reclaimed because their beneficial owner is non-resident, a balance of 15 per cent, representing United States tax, will be withheld from the repayment eventually made. The tax so withheld is then passed on to the United States Treasury.

Zambia

There is an arrangement with the United Kingdom Overseas Tax Office for the collection of tax on Zambian pensions paid to persons resident in the United Kingdom. No arrangements exist in Zambia for the collection of foreign tax. With the introduction of the Tax Clearance Act, it is not considered necessary for Zambia to enter into any agreements for the collection of Zambian tax, or vice versa.

Other countries

Fiji, Iran and the Philippines each expressed itself in favour of reciprocal agreements with respect to international co-operation in the collection of income taxes, although they currently have none.
VI. SIMPLE METHODS OF INTERNATIONAL INCOME-TAX EVASION *

As used in this discussion, the term “international tax evasion” means 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. The discussion thus describes situations in which the domestic tax system substantively taxes the international income involved, but this substantive obligation is being evaded by illegal action. The evasion here dealt with thus arises from a conscious failure to comply with existing rules.

Because the tax laws of different countries vary in many respects, acts that are clearly illegal in some countries may be arguably or clearly legal in other countries. Hence, this summary of methods used for international tax evasion may be only partially applicable in the case of any one country.

A. Evasion of taxes imposed by the country of residence or citizenship

Many countries impose income taxes on income received from abroad by residents or non-resident citizens of the country. The simple techniques for evading tax on such income are described below:

(a) Failure to file a return. One of the most common forms of international tax evasion is the deliberate failure by resident aliens to file tax returns in the country in which they are residing. Persons who spend a portion of each year in several different jurisdictions frequently make inconsistent claims of residence. For example, a person who is present for part of the year in both countries \( A \) and \( B \) may take the position in country \( A \) that he does not have to file a return because he is a resident of \( B \); while he simultaneously claims in country \( B \) that he does not have to file a return because he is a resident of \( A \). Where a country taxes all international income of its citizens, a citizen who is residing abroad may evade tax by failing to file a return in the country of his citizenship;

(b) Failure to report all income subject to tax. One of the most direct forms of international tax evasion is wilful failure to report all items of international income that are subject to tax. The three items most often omitted from tax returns are salaries, investment income and business profits:

(i) Salaries: residents of a particular country who are performing services in that country frequently fail to report compensation received for those services from sources outside the country. Suppose, for example, that a parent firm in country \( A \) sends one of its employees to country \( B \) to work full-time for a subsidiary enterprise located in country \( B \). The employee will frequently receive part of his total compensation from the parent firm in country \( A \) and the balance from the subsidiary in \( B \). On the return that he files as a resident in country \( B \), the employee will report only that portion of his compensation which was paid to him in local currency by the subsidiary in \( B \), even though the law of \( B \) clearly provides that his entire compensation is subject to tax. While this device constitutes evasion under the laws of many countries, it should be mentioned that it is legal under the laws of certain other countries, so long as the funds paid by the parent firm to the employee are not brought inside the country in which he is working;

(ii) Investment income: a resident of one country who derives investment income from another country frequently fails to report such income on the tax return which he files in the first country, particularly where the income is deposited outside the first country or the investments are held in the form of bearer securities;

(iii) Business profits: tax is frequently evaded by means of a deliberate failure to keep accurate books and records within the taxing jurisdiction. Frequently, a second set of books, which is accurate, is maintained outside the taxing jurisdiction; but those records are normally beyond the reach of the authorities of that jurisdiction. In some instances, the maintenance of false books within the taxing jurisdiction is facilitated by limitations in domestic law on the extent to which the taxpayer’s books and records may be examined by the taxing authorities;

(c) Fictitious deductions. In a variety of circumstances, fictitious business expenses may be claimed as deductions, particularly if the purported recipient of the expense payment is outside the taxing jurisdiction and is therefore not subject to audit by the tax authorities of that jurisdiction. For example, if the taxpayer purchases goods outside the taxing jurisdiction, false invoices may be prepared to show a purchase price greater than that actually paid by the taxpayer. Furthermore, in many cases, commissions, royalties, technical service fees and similar expenses are paid by a resident of the taxing jurisdiction to a related non-resident and claimed as deductions, even though the related non-resident has done nothing to earn such fees.

* In the preparation of this chapter, the United Nations Secretariat had the assistance of Stanley S. Surrey, Harvard University Law School, International Tax Program, Cambridge, Massachusetts, United States of America, and George Beatty, attorney, Washington, D.C.
(d) Fictitious credits. A taxpayer residing in country A and receiving international income from country B may seek to evade tax in country A, which allows a foreign tax credit as a method of relieving double taxation, by claiming fictitious or excessive credits for taxes allegedly paid to country B;

(e) Improper characterization of income or expense items. Tax may be evaded by improperly characterizing an income or expense item in order to make use of an exclusion or reduced rate. For example, non-deductible bribes to foreign officials may be labelled as deductible business expenses;

(f) Inconsistent characterizations. A taxpayer may characterize a particular transaction in one way in country A, and in a contrary way in country B, in order to obtain tax benefits in each country. For example, advances by a parent firm in country A to a subsidiary in country B may be treated as equity in country A (in order to avoid the necessity for reporting interest income to country A), but as debt in country B (in order to avoid capital-stock taxes in country B). Payments made by a subsidiary in country A to its parent firm in country B may be treated as the purchase price of goods in country A, but as royalty or dividends in country B. In some cases, however, apparent inconsistencies of this type may be justified by differences in the internal laws of the two jurisdictions;

(g) Utilizing temporary taxpayer status. Where taxation is based on status temporarily attained, tax evasion may occur through transactions that take advantage of that temporary status. For example, because loan proceeds are not taxable to the borrower, a foreign national may arrange an ostensible borrowing while he is a resident of the taxing jurisdiction and then sell the collateral for the alleged loan to the lender following his departure from the taxing jurisdiction (when he is no longer taxable on sales profit within that jurisdiction), with the "loan" being credited against the sales price;

(h) Flight to avoid payment of tax. Where the taxing jurisdiction determines that a resident alien has taxable income or assesses a tax against him, the individual may flee the jurisdiction to escape tax. Even though the authorities of the taxing jurisdiction have properly assessed the tax, it is collectible only to the extent of the taxpayer’s property within the reach of the administrative and judicial collection power. As a rule, that power is limited to the taxing state and its possessions. Thus, to the extent that property is removed from the taxing jurisdiction, it is generally immune from collection because the courts of one country will not enforce a judgement for taxes rendered by the courts of another country. 1


B. Evasion of taxes imposed by the country of source

Tax on income derived from sources within the taxing country by non-residents is usually collected by requiring the payer of the income to withhold the tax before remitting the balance of the payment to the non-resident. A number of common techniques exist for evading the payment of these withholding taxes:

(a) False withholding certificates. Tax may be evaded by providing false information to withholding agents. For example, a payer of dividends having no definite knowledge of the status of a shareholder is usually not required to withhold tax if the payee’s address is within the country of the payer. Accordingly, non-resident alien recipients frequently establish a false address within the country, or cause the income to be paid to a co-operative nominee within the country, in order to escape withholding. This method of evasion depends upon the willingness of the nominee to violate the law by failing to withhold tax when the nominee makes remittances to the true owner outside the country;

(b) Use of bearer securities. In many instances, withholding taxes can be avoided by holding securities in bearer form, particularly if they are in the custody of a broker, nominee or agent within the country of the issuing corporation. This method of evasion also depends upon the person holding the bearer securities being prepared to violate the law by failing to withhold when remittances are made to the true owner;

(c) Abuse of treaty provisions. A resident of country A who wishes to derive investment income from country C may establish an entity in country B to make such investment solely because the withholding tax rate on income payments from country C to country B is lower by reason of a treaty than the withholding rate on payments from country C to country A. If the resident of country A has no other contact with country B, his use of the entity in B for this purpose constitutes a clear abuse of the treaty provisions, even if it is technically legal;

(d) Erroneous characterization of income items. Where the withholding rates on certain types of income are lower than the rates on other types of income, related entities frequently disguise the true character of a payment in order to take advantage of the lower rate. For example, dividends may be paid in the guise of fees or commissions;

(e) Unreported income and fictitious expenses. An individual who is temporarily present in the taxing jurisdiction, but is neither a resident nor a citizen, may evade tax on income earned while he was in the jurisdiction by either understating his true income or overstating his true expenses. The techniques used are frequently the same as the first three discussed above in section A.

C. Institutional devices and arrangements facilitating evasion

A number of institutional devices are used to conceal the existence of international income or to generate fictitious deductions, thereby facilitating international income-tax evasion:
(a) Use of dummies, nominees and numbered bank accounts. The existence of salaries, investment income, business profits and other items of international income is frequently concealed by having the items paid to dummies, nominees or numbered bank accounts inside or outside the taxing jurisdiction. For example, an official of country \( A \) may state that he will permit a subsidiary in country \( A \) to make certain remittances to its parent firm in country \( B \) only if the parent firm makes an unreported payment in funds of country \( B \) to a nominee of the official (or a numbered bank account maintained by him) in country \( B \) or \( C \). Similarly, a resident of country \( D \) who sells property at a gain to a resident of country \( E \) may stipulate that the sales proceeds are to be deposited in a numbered bank account inside or outside country \( D \). Once an item of international income has been concealed in a numbered bank account or in the name of a nominee, the amount in that concealed account can be used to generate investment income which will likewise be concealed from the taxing authorities of the country in which the true owner of the account is residing;

(b) Use of bearer securities. In order to conceal the receipt of dividend or interest income, international investors frequently place investments in bearer form. The use of bearer securities also facilitates the transfer of investments from one owner to another without reporting the transaction and paying the tax due by reason of the transfer. It is difficult to police such transactions from a tax standpoint because the use of bearer securities is widespread and entirely legal in most countries;

(c) Use of foreign holding companies and trusts. Under the laws of some countries, a resident may legally avoid tax on investment income by placing his income producing property in a foreign holding company or trust which he controls. Under the laws of other countries, however, the investment income is taxable by the country of residence whether or not it is actually distributed by the foreign holding company or trust to the resident owner. In cases of the latter type, tax is frequently evaded by illegally concealing the existence of the foreign holding company or trust from the tax authorities of the country of residence;

(d) Artificial bank loans. A major technique for international tax evasion consists of purportedly borrowing funds which are actually owned by the borrower. This technique not only enables the “borrower” to make open use of funds previously concealed in the name of a nominee or in a numbered bank account, but gives the borrower a pretext for claiming fictitious interest deductions. For example, a resident of country \( A \) who has deposited unreported international income in a numbered bank account in country \( B \) will arrange to “borrow” an equivalent amount from that bank at 8.5 per cent interest. If the bank is paying 8 per cent interest to him on his numbered account, he will actually be out of pocket only 0.5 per cent; but on the return that he files in country \( A \), he will treat the receipt of the unreported income as a “loan” and will claim a deduction for the entire 8.5 per cent interest charge he pays to the bank. To disguise further the facts, a resident of country \( A \) with a numbered bank account in country \( B \) may arrange to have the bank in country \( B \) forward funds to an unrelated bank in country \( C \), from which he will then “borrow” an equivalent amount;

(e) Investment trusts. By concentrating funds from many different sources in a single investment pool, an international investment trust may make it possible for many different investors to evade tax simultaneously. It is suggested that further study be given to the role being played by such trusts to determine whether they are, in fact, being used as vehicles for evading international income taxes.

D. Use of related tax haven entities to evade taxes

Entities in tax haven countries are frequently utilized to reduce taxes in a fashion that is legal under the framework of current tax systems. In addition to fostering legal methods of reducing tax, however, the presence of tax haven countries invites tax evasion activities which turn on an essentially false or illegal relationship with the tax haven country. Some of these latter situations are described below:

(a) Transfer of income-producing assets to a tax haven entity. Tax evasion may occur where income-producing assets are transferred at an artificially low cost from the taxing jurisdiction to a controlled entity in a foreign tax haven country where the potential income from the assets will be subject to tax at a lower rate or escape tax entirely. The assets transferred to the foreign tax haven company may consist of:

(i) Stocks, securities, rental properties and intangibles, such as licensed patents, trademarks and copyrights, which will generate continuing passive investment income; or

(ii) Property of any kind, which will be resold by the tax haven entity to unrelated third parties at a gain.

In many cases, there is no limitation on the amount of income that may be accumulated free of tax in the foreign tax haven entity;

(b) Transfer of income-producing functions to a tax haven entity. An entity in a country with a high tax rate frequently evades tax by arranging to render services to unrelated parties through a controlled entity in a tax haven jurisdiction. In the typical evasion case, the controlled entity is a shell corporation which is incapable of performing the services unless it uses personnel and/or property of the controlling entity;

(c) Payment of deductible expenses to a tax haven entity. An entity in a high-tax jurisdiction may pay management fees, technical service fees or other deductible fees to a related entity in a tax haven jurisdiction, which has not actually earned those fees and will not have to pay appreciable tax on them;

(d) Payment of deductible expenses benefiting a tax haven entity. An entity in a high-tax country may incur deductible expenses in acquiring or developing property which is then made available without adequate reimbursement to a related entity in a tax haven country. For
example, the entity in the high-tax country may take interest deductions with respect to borrowed funds which are re-lent to the related entity free of interest. Similarly, the entity in the high-tax country may take depreciation deductions for tangible property or research expense deductions for intangible property, which is leased or licensed to the related entity for an artificially low consideration.

It should be reiterated that some of the techniques described above may be legal methods of reducing tax, rather than illegal methods of evading tax, depending upon the law of the particular countries involved.
VII. METHODS FOR ELIMINATION OF DOUBLE TAXATION *

A. Double-taxation relief provisions in capital-exporting countries

UNITED STATES OF AMERICA

Statutory law

The current tax law of the United States of America does not include provisions specifically designed to encourage investment in developing countries. There are, however, some special rules that may benefit such investments and others that remove certain tax disadvantages in favour of investments in developing countries.

Among the statutory rules that may benefit investments in developing countries, although they were not designed for this purpose, are those on Western Hemisphere Trade Corporations, possessions corporations and China Trade Act Corporations.

Western Hemisphere Trade Corporation

A Western Hemisphere Trade Corporation, regulated in sections 921 and 922 of the Internal Revenue Code, is a United States corporation that meets certain requirements. Except for incidental (insignificant) purchases, all of the business of the corporation must be done in northern, central or southern America, or in the Caribbean area. At least 95 per cent of the gross corporate income must be from sources outside the United States of America, and at least 90 per cent thereof must be derived from the active conduct of a trade or business. The last-named requirement implies that not more than 10 per cent of the gross corporate income can be passive investment income, such as dividends, interest or royalties. If the statutory conditions are met, the corporation is taxed at a maximum rate of 34 per cent, i.e., at a rate that is 14 percentage points lower than the regular corporate tax rate of 48 per cent.

The rules on Western Hemisphere Trade Corporations became part of United States tax law in 1942, and their origin is somewhat obscure. It appears that the United States Congress in that year exempted Western Hemisphere Trade Corporations from the corporate surtax (which was then increased from 7 per cent to 16 per cent) upon the representations of a few United States corporations engaged in direct business operations in Latin America. The tax reduction, which eventually amounted to 14 percentage points, was not established for exporters, who are currently the principal beneficiaries of these preferential rules.¹

Possessions corporation

A possessions corporation, regulated in section 931 of the Internal Revenue Code, is a United States corporation deriving at least 80 per cent of its gross income from sources in a possession of the United States and at least 50 per cent thereof from the active conduct of a trade or business in a possession. A qualified possessions corporation is exempt from United States income tax except in so far as income (from any geographical source) is received in the United States.

The principal use of the possessions corporation by United States business has been in Puerto Rico. The combination of the exemption from United States tax and the tax holiday of from 10 to 15 years extended under the various incentive laws of the Commonwealth has been of extraordinary benefit to United States corporations that establish manufacturing activities on the island. Another significant advantage of the possessions corporation, as compared with a subsidiary organized under Puerto Rican law, is that it can be liquidated tax-free into the parent firm after its functions are completed or the tax holiday granted by Puerto Rico has ended.

China Trade Act Corporation

China Trade Act corporations, regulated in sections 941-943 of the Internal Revenue Code, are currently of very limited significance. One of the leading tax services in the United States of America reports that there are currently only four active China Trade Act Corporations, in addition to about 50 inactive ones.²

A corporation organized under the China Trade Act is subject to the same normal tax and surtax as a domestic corporation, but the computation of the tax base differs in that under certain conditions a special deduction is allowed for taxable income derived from sources in, among other areas, Hong Kong.

The special deduction is an amount equal to the proportion of taxable income from Hong Kong or other countries specified that the par value of the shares owned by residents of these countries or of the United States of America, or individual citizens of the United States, bears to the par value of the entire outstanding share capital. The decrease in tax because of the special deduction cannot exceed the amount of the "special dividends" which the corporation is required to distribute after the end of the taxable year.

The Revenue Act of 1962 introduced sweeping changes in the taxation of United States corporations with foreign operations or investments. Prior to that Act, those corporations were free to accumulate income or distribute it among their foreign subsidiaries without imposition of United States tax by using holding companies in so-called “tax haven countries”. They were also able to make sales or render services abroad through controlled foreign corporations free of United States tax. Abuses resulting from those methods of operation led to a proposal by the Kennedy Administration to tax all income of controlled foreign corporations directly to their United States shareholders regardless of the nature of the income and the level of taxation in the country of domicile, as if that income had been distributed to the shareholders as a dividend. This somewhat extreme proposal was toned down in subsequent Congressional hearings, with the result that the final statute attributed only certain income to the United States shareholders for immediate taxation. The types of income attributed under these rules are termed foreign personal holding-company income (essentially, passive investment income), foreign base company sales income (income from sales of personal property by a controlled foreign corporation if a related party acts as buyer or seller) and foreign base company services income (income from services rendered by a controlled foreign corporation on behalf of the parent firm or another related party). In addition, investments by a controlled foreign corporation in United States property, such as shares of, or loans to, United States corporations, are taxed to the shareholders for the reason that such investments are deemed to be substantially equivalent to a dividend distribution.

The Revenue Act of 1962, the provisions of which were subsequently incorporated in sections 951 et seq. of the Internal Revenue Code, provides for relief from the attribution rules in favor of certain qualifying investments in what are precisely defined by statutes as “less developed country corporations”. In general, this means a foreign corporation engaged in the active conduct of one or more trades or businesses deriving at least 80 per cent of its gross income from sources in developing countries, and retaining at least 80 per cent of its assets, except for bank accounts, in such countries. If these conditions are met, taxation of foreign personal holding-company income, which, under the general rules, is attributed to United States shareholders, is deferred as long as such income is directed into certain qualified investments in developing countries.

The exclusion just described is very limited. It applies only to one type of foreign base company income, namely, personal holding-company income. No relief is provided for base company sales or services income. In addition, the exception is limited to three types of personal holding-company income, i.e., dividends, interest and capital gains from sales or other dispositions of qualifying investments in developing countries. Income from rentals or royalties is not covered by the exception. Lastly, the exclusion is limited to amounts that are both derived from and reinvested in qualified investments in “less developed countries” as defined in the statute. Amounts derived from sources in industrialized countries do not qualify for the exclusion even if they are reinvested in developing countries.

Another rule provides that income from shipping and air transportation is exempt from the attribution rules if the vessel or aircraft producing the income is registered under the law of a developing country. This rule was not designed primarily as an incentive for investments in developing countries. Its purpose is to encourage and protect investments in United States ships operating in foreign commerce.

With respect to foreign base holding-company income (passive investment income), there is no requirement to gross up dividends received from controlled foreign corporations in developing countries. As a result, the United States tax basis and the over-all tax burden are smaller than in the case of dividends from subsidiaries in industrialized countries.

Special rules also apply with respect to capital gains from the sale or other disposition of investments in “less developed country corporations”. According to section 1248 of the Internal Revenue Code, gain from the sale or exchange of stock in a controlled foreign corporation or from the liquidation of such a corporation is, as a rule, taxed at ordinary income-tax rates as if the distribution were a dividend. However, gain attributable to earnings and profits earned while the controlled foreign corporation was a “less developed country corporation” is exempt from this rule; and the distributions are taxed at the reduced rates for capital gains, provided that the stock of the foreign corporation was held continuously for a period of at least 10 years prior to the sale or liquidation.

This treatment is designed to add to the attractiveness of investments in developing countries. It is of limited usefulness to corporate shareholders because the indirect foreign-tax credit (credit for taxes paid by the foreign corporation) is not permitted with respect to distributions that are taxed at capital-gain rates. In addition, the increase in the rate of the United States capital-gains tax introduced by the Revenue Act of 1969, amounting to 30 per cent for corporations, reduces the value of the exceptions.

Tax treaties

The treaty with Pakistan (1957) is the only income-tax convention currently in effect between the United States of America and a developing country. The treaty with Honduras (1956) was terminated by that country as of 31 December 1966. The treaties with India (1959), Israel (1960) and the United Arab Republic (1960) were withdrawn by the United States because the tax-sparing credit included in those treaties was unacceptable to the Administration and the United States Senate. The treaty with the Philippines (1964) has not been ratified, although more than seven years have passed since it was signed. The treaties with Israel (1965) and Thailand (1965), which provide for an investment credit and tax deferral for technical assistance, are not likely to be ratified, as the domestic investment credit was repealed in the United States and the United States Senate rejected the relief measures included in those treaties. The same situation probably holds for the treaty with Brazil (1967), which provides for an investment credit. The treaty with Trinidad
and Tobago (1970) grants tax deferral for technical assistance; as the Foreign Relations Committee of the United States Senate has registered a reservation concerning this relief measure, the treaty is likely to be ratified without it.

The relief measures included in the various tax treaties between the United States of America and developing countries, and the status of those treaties, are given in table 2 above.

FRANCE

Statutory law

Principle of territoriality

French tax legislation does not offer special incentives for investments in developing countries, except in the overseas departments (Guadeloupe, Martinique, Guyana and Réunion), which are considered part of France. The tax benefits extended by France under treaties to certain developing countries—in particular, former colonies and other French-speaking territories in Africa—are discussed below.

On the other hand, the principle of territoriality, which has governed the French system of income taxation since its beginnings, acts as a limitation on the taxation of certain types of foreign-source income. This principle is also the only unilateral measure for the avoidance of double taxation. The foreign-tax credit is recognized as a matter of statutory law only for purposes of the consolidated returns discussed below and is applied under tax treaties.

The characterization of income as domestic or foreign is made according to principles that differ for various types of income. Export sales made directly to the foreign customer or through an independent foreign agent are considered to be closely connected with the operations carried on in France and are, for this reason, held to result in domestic income or loss. The same principle applies to the construction of a factory, the assembly of equipment, the rendition of services or the transmission abroad of know-how. Income from capital, such as

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3 France, Code Général des Impôts, arts. 34 and 209. The turnover tax (TVA or added-value tax), which accounts for more than 40 per cent of total tax revenue, is a strictly territorial tax. Imports are taxed in the same manner as the first sale of domestic goods, and exports are exempt from the tax.

4 Accordingly, foreign withholding taxes imposed on a French corporation are deductible from income and are not a direct offset against the French tax.
interest, dividends or royalties which a French enterprise receives from a foreign debtor, corporation or licensee, are treated as domestic income unless the income originates in a foreign branch or other foreign establishment.

Business income in the narrow sense (industrial or commercial profits) is deemed to be derived from foreign sources if it originates in a foreign branch or other permanent establishment, through the activities of a dependent agent or representative stationed abroad, or as a result of a "complete commercial cycle" consummated abroad. These three sources of foreign income are briefly discussed below.

Foreign branch

In order for the profits of a foreign branch or other foreign establishment of a French enterprise to be exempt from French income tax, the branch or establishment must be an "autonomous organization", i.e., a commercial or industrial unit that is established abroad on a permanent basis and with a certain measure of independence. The organization must carry on activities that are apt to result in the realization of profit, and it must be under the direction of a person who has authority to conclude binding contracts on behalf of the French enterprise. It follows from the principle of territoriality that neither profits nor losses of the foreign establishment are considered for French tax purposes, except if the branch is included in a consolidated return of the main office, as discussed below.

There are certain exceptions to the rule of territoriality which are dictated by business necessities:

(a) Tax deferral for the cost of certain establishments. The installation cost of foreign sales offices, research facilities or information centres is deductible in computing the taxable income of the French enterprise. The same rule applies to the current expenses of these facilities for the first three years of operation. The amounts so deducted must be restored to income over a period of five business years beginning with the fourth year after the organization of the foreign facility, and in equal annual amounts. The tax benefit, which does not apply to facilities in the French overseas departments or the French-speaking countries of Africa, thus amounts to a deferral rather than a forgiveness of tax. A permanent deduction may be allowed, however, to promote the sale of French products abroad, if the French Ministry of Economics and Finance, after consulting the managing board of the Development Fund, agrees that the investment is useful for that purpose.

(b) Inclusion of foreign branches in tax return. French tax law permits a domestic enterprise, with the consent of the Ministry of Economics and Finance, to include in its tax return the operating results of its foreign branches,

If a French corporation owns as little as 10 per cent of the share capital of another corporation, whether French or foreign, only 5 per cent of the dividends distributed by the latter corporation is subject to French income tax. Although this rule is unconnected with the system of territoriality, it results in a quasi-exemption of one of the most important types of foreign-source income.

Royalties, however, are taxed at the preferential rate of 10 per cent, which otherwise applies to long-term capital gains.

or of its foreign branches and subsidiaries. The election is irrevocable, subject to certain exceptions. Under either form of consolidation, a foreign-tax credit can be claimed on the per-country basis, and losses of foreign branches or subsidiaries can be offset against profits of the parent firm or other members of the group. The profits or losses of the foreign branches or subsidiaries must be restated in accordance with French law.

Dependent agents

Even in the absence of a foreign permanent establishment, a French enterprise derives non-taxable income from foreign sources if the income is realized through the activities of a dependent agent or other representative stationed abroad. Although the representative need not be an employee, he must be subject to directions with respect to his functions and the results to be accomplished; and he must have authority to enter into binding agreements on behalf of the French enterprise. An agent who is an independent contractor and who is not subordinated to the enterprise and thus has a "legal personality distinct from that of the French principal" does not qualify under this rule.

Complete commercial cycle

A French business enterprise is not taxed on income from a "complete commercial cycle" that is consummated abroad. This requirement implies that all activities necessary to realize a specific profit are carried on outside France and that these activities are distinct and separate from domestic operations. A principal example of the "complete commercial cycle" is the purchase or manufacture of merchandise and the sale thereof outside France.

Since profits from the three types of operation summarized above are exempt from French tax, the French enterprise should maintain separate accounting records to serve as the basis of taxation for its domestic and foreign operations. Even if such records are maintained, it may still become necessary for the tax authorities to allocate general expenses partially to domestic operations and partially to foreign operations, such as the salaries of executive employees whose activities benefit both. If an expenditure benefits only domestic or only foreign operations, such as a loan taken up exclusively for the benefit of the domestic or the foreign establishment, the expense can be deducted only by the establishment that received the benefit thereof. Expenses that are not clearly allocable to either domestic or foreign operations must be apportioned between both. The French tax administration also insists that the head office receive a normal remuneration for capital or credits that it makes available to a foreign establishment.

If the enterprise does not maintain accounting records that clearly reflect the activities and income of the various establishments, the total profit is allocated according to rules that vary with the nature of the enterprise. If the foreign operations are comparable to those carried on in

7 The tax benefit is termed bénéfice mondial if only foreign branches are included in the tax return, and bénéfice consolidé if foreign branches and foreign subsidiaries are included.
France, the allocation can be made on the basis of the relative gross income of the establishments. If the foreign operations are considerably more or considerably less lucrative than the domestic operations of the enterprise because of peculiar facts, different allocation methods may be applied. One method would be to assign to the head office the portion of the total profit corresponding to the profit that a comparable French enterprise would realize from comparable operations. The profits of foreign insurance enterprises engaged in business in France may be computed by applying to the premiums collected the coefficients that are determined by the Government from year to year and that represent the average profit that French insurance enterprises realize from similar operations.

**Tax treaties**

Among the developing countries, France has concluded tax treaties with former colonies which are now overseas territories or protectorates (Morocco), or territories under French "tutelage" (Cameroon and Togo).

The treaties cover income tax, inheritance tax, indirect taxes (droits d'enregistrement) and stamp taxes (droits de timbre). The extensive coverage of these treaties is explained by the fiscal systems of the countries of Africa which were derived from the French tax system and retained after independence. The treaties also include provisions for exchanges of information between the Governments upon request and for the recovery by one of the treaty countries of taxes owed to the other country.

The rules summarized below are typical for all treaties between France and the countries of Africa, excluding the treaty with Madagascar.

**Definition of permanent establishment**

The treaties apply the OECD definition of the term "permanent establishment" with modifications that enlarge this concept. They give consideration to the absence of a reciprocal flow of investment between France and the countries of Africa and to the needs of the latter countries to conserve their revenue.

Accordingly, a construction or assembly project is treated as a permanent establishment under these treaties, regardless of the period for which it is carried on. The same rule applies to any fixed installation of an enterprise used for storage, exhibition or delivery of merchandise and to an inventory of merchandise belonging to the enterprise. The term "permanent establishment" further includes installations for the collection of information, such as an office of a newspaper or news agency in the other country, and purchasing offices. The last-named provision is directed at enterprises that specialize in the purchasing of raw materials or colonial products in the developing countries, on the ground that the profit from the sale of these items should, in part, be allocated to the country that supplied the goods sold.

**Agents and other intermediaries**

Tax conventions usually provide that if a representative has power to contract in the name of his principal in the other treaty country, the latter has a permanent establishment in that country even if there is no fixed installation of any kind. Very often, such a power is not given to the agent in order to ensure that the enterprise shall not be forced to litigate outside its home country. Apart from the question of the proper forum, the power to conclude contracts in the name of the enterprise is often a mere formality and does not correspond to the realities of the situation, because of the important role of the agent in the transactions carried out by him. For this reason, the treaties with the developing countries establish an irrefutable presumption that the agent has power to conclude contracts if he habitually makes deliveries from an inventory of merchandise belonging to the enterprise and regularly fills orders for the latter's account.

Similarly, the conventions provide that an enterprise of one of the treaty countries will be deemed to have a permanent establishment in the other country if it executes commercial transactions in that country through a broker (courtier), a commission agent (commissionnaire) or another agent of independent status who has a consignment inventory from which sales and deliveries are made.

With respect to insurance enterprises, the signing of the contract is, in most cases, an empty formality which is usually performed at the seat of the enterprise. Therefore, insurance enterprises are treated as having a permanent establishment in the other treaty country as soon as they insure risks or collect premiums in that country through a dependent agent.

**Determination of taxable profits**

The comprehensive definition of the term "permanent establishment" favours the fiscal independence of developing countries. On the other hand, it has the disadvantage of complicating the determination of taxable income. For this reason, the treaties include some practical rules which help resolve this point.

The profit of the permanent establishment is usually determined on the basis of the results shown in the accounting records of the establishment and the enterprise as a whole. A portion of the general expenses is allocated to the establishment on the basis of gross turnover (chiffre d'affaire). If the permanent establishment does not have a reliable accounting system, the profit attributable to it is determined by allocating the total profit in the ratio of the turnover of each establishment. This method is frequently applied to insurance enterprises.

Even though the methods used may appear inadequate, litigation is quite rare. This is due in part to the fact that the rules in France and in the countries of Africa are similar and that tax officials of the developing countries very often receive their technical training in France.

**Division of tax**

Most tax treaties between France and the countries formerly under its political control provide that an enterprise of one of the countries that conducts business operations in the other country is subject not only to profits tax, but to tax on that portion of the dividends distributed by it which is deemed to have its source in the developing country. This rule, which has been the
law in France since 1872, equalizes the tax situation of branches and subsidiaries. The allocatable portion (quantité imposable) is computed according to the relative values of the assets maintained in France and total assets. In effect, the tax is shared between the two countries according to a formula that precludes double taxation.

**Salaries and pensions**

As a general rule, the tax treaties concluded by France provide that salaries are taxable in the country where the services are performed. This rule does not apply to merely temporary business visitors or to government officials who do not carry on a commercial or industrial activity. The treaties between France and the countries of Africa do not include these limitations and exempt only diplomatic and consular personnel.

Public or private pensions are taxable only at the beneficiary's residence. This is an unusual rule which is not found in other treaties, except for government pensions.

**The matching credit**

In order to encourage French enterprises to initiate or continue activities in the French-speaking countries of Africa, France grants a fixed foreign-tax credit of 25 per cent for dividends and 12 per cent for bond interest from sources in those countries. These credits are computed on the gross amount of the income, and they apply regardless of the tax rate of the African country. The rule permits the developing countries to fix their withholding taxes at rates that can be absorbed by the French tax. Another effect of this rule is that it removes an incentive to tax competition between the developing countries. Since the rule is the same for subsidiaries and branches, French enterprises can transform their branches in developing countries into subsidiaries without imposition of French tax if such a reorganization becomes necessary.

**Federal Republic of Germany**

**Statutory law**

In a manner similar to that followed by other industrialized countries, the Federal Republic of Germany taxes its residents and business enterprises on a worldwide basis. Most of the statutory relief measures for the prevention or mitigation of double taxation apply to all foreign investments, although some of these measures have been liberalized in favour of investments in developing countries. The generally applicable measures include the foreign-tax credit, taxation of foreign income at a flat rate, relief in connexion with the exchange of a domestic investment for a foreign investment and the transfer of fixed assets abroad, and a limited deduction for operating losses sustained by foreign subsidiaries or permanent establishments. In addition to these tax benefits, there are special statutory relief provisions for investments in developing countries. These measures, and the more far-reaching ones applying under tax treaties, are discussed below.

**Statutory measures applying to all foreign investments**

**Foreign-tax credit**

The foreign-tax credit can be claimed by all persons who are residents of the Federal Republic (or West Berlin), as determined under German law. The credit applies, on the basis of reciprocity, for purposes of the taxes on personal or corporate tax and the net-worth tax. Reciprocity is conclusively presumed to exist if the foreign country has a tax treaty with the Federal Republic which covers these taxes.

The income-tax credit can be claimed for foreign taxes that are substantially similar to the German income tax. This requirement limits the credit to taxes that apply in the entire area of the foreign country. While the taxpayer is thus precluded from claiming the credit as a matter of right for income taxes levied by provinces, states or other political subdivisions of a foreign country, the tax authorities have, from time to time, granted administrative relief in such cases.

The credit is limited to the amount of German income tax that is attributable to the foreign income. Accordingly, the German source rules must be considered, especially since they deviate in important respects from those of some other industrialized countries. For example, business income is considered foreign-source income only if it is derived through a foreign permanent establishment or a representative who is permanently stationed abroad. Income from straight export sales is classified as domestic income. There has been some doubt as to whether royalties from the licensing of unprotected inventions and know-how fees paid by a non-resident are foreign-source income; the tax authorities, however, have accepted this characterization in order to grant relief.

German tax law currently recognizes only the per-country limitation on the foreign-tax credit, for the reason that the over-all limitation favours the foreign country with the highest tax rate and is thus apt to distort the investment decision where an investment in a high-tax foreign country is made only because investments are also made in foreign countries with low tax rates. If a foreign subsidiary distributes a dividend, credit is allowed for the withholding tax of the foreign country, but not for any part of the income taxes imposed on the foreign entity. There is no carry-over or carry-back of unused foreign-tax credits, and no deduction is permitted for the non-creditable portion of a foreign tax.

Similar to the foreign-tax credit for income taxes, the credit for foreign net-worth taxes is limited to foreign taxes that are substantially similar to the German tax. This requirement is not met by foreign taxes imposed on individual types or classes of property, as distinguished from the taxpayer's entire net worth, such as real-estate taxes or taxes on personal property. The limitations on the credit described above apply.

**Flat-rate taxation**

The German tax authorities are authorized by statute to forgive taxes on foreign-source income and foreign-situs property entirely or in part, or to assess those taxes at a flat rate if either procedure is in the interest of the
German economy, or if the computation of the foreign-tax credit is "unusually difficult". These rules apply exclusively to income from sources in non-treaty countries and net-worth taxes on such investments, and they are designed to equalize the tax burden on such income or property to some extent with that of investments in treaty countries.

Flat-rate taxation takes the place of the foreign-tax credit. Unlike the latter, it is not given effect automatically, but must be applied for by the taxpayer. It can be claimed for: (a) profits of a foreign permanent establishment or unincorporated association and capital appropriated to the establishment or association; (b) intercompany dividends from a "substantial participation", i.e., an investment by a German commercial entity in a foreign commercial entity which amounts to at least 25 per cent of the latter's share capital and was held from the beginning of the German entity's taxable year. The underlying investment is exempt from German net-worth tax.

The income-tax rate on income from qualifying investments is a uniform 25 per cent, or about one half of the regular corporate rate of 51 per cent. The rate of the net-worth tax is exactly one half of the regular rate, or 0.5 per cent.

In order to invoke the tax benefit, the foreign permanent establishment, association or entity must be engaged exclusively or "almost exclusively" in manufacturing or trading activities, the rendition of commercial services in the foreign country, or the importation of merchandise from the foreign country to the Federal Republic of Germany; the foreign establishment, association or entity is deemed to be so engaged if 90 per cent or more of its income is derived from such activities. The purpose of this rule is to reserve the tax benefit to investments that serve the active conduct of a business, as distinguished from investments in foreign holding companies.

Flat-rate taxation applies only in the absence of a tax treaty. Since the Federal Republic has double-taxation conventions with most industrialized countries, this method of taxation applies primarily in relation to developing countries that have not concluded a tax treaty. In addition to the incentives discussed above, which benefit income from foreign sources and property situated abroad, there are others which are independent of these factors and apply whether or not the foreign investment is profitable.

*Exchange of domestic investment for foreign investment*

Resident individuals or entities that sell or otherwise dispose of an investment in a domestic commercial entity held for at least six years can reduce the basis of a foreign equity investment that is acquired in the year of the sale or the next following two years. The reduction of basis is equal to the amount of gain realized on the disposition of the domestic investment. In effect, the taxation of the gain from the disposition of the original investment is deferred until such time as the new investment is sold or liquidated; if it is retained, the deferral becomes a permanent exemption. The tax benefit can be claimed if the foreign entity is engaged exclusively or almost exclusively in the production or sale of merchandise, the extraction of natural resources, commercial services, or agriculture or forestry. The rental or leasing of tangible properties or the leasing of intangible properties does not qualify for the tax benefit. In addition to these requirements, the application of the tax benefit is further dependent upon certification by no less than three government agencies to the effect that the investment in the foreign entity is meritorious from the standpoint of the economy of the Federal Republic and is suited to promote division of labour or increased co-operation on the international level.

*Transfer of fixed assets abroad*

Foreign investments can be financed through cash contributions or transfers of operating assets abroad or a combination of the two. In many cases, the domestic enterprise makes patents or know-how available to its foreign branch or subsidiary. Under general rules of German income-tax law, the transfer of depreciable fixed assets — e.g., machinery, industrial equipment or patents — may be a taxable transaction because it results in the disclosure of the so-called "secret reserves", i.e., the difference between the written-down book values and the actual fair-market values of the assets transferred. The difference between the two values is taxable if the transferee is not subject to German tax jurisdiction. It follows that gain is recognized and becomes taxable if the transferee is a foreign subsidiary or foreign permanent establishment of the transferor in a country that has a tax treaty with the Federal Republic. A transfer to an establishment in a non-treaty country, as one between several domestic establishments of an enterprise, does not give rise to taxable income.

In order to encourage the formation of foreign subsidiaries and establishments, German tax law provides for deferral or non-recognition of gain from the transfer of assets abroad in certain cases. Technically, deferral is accomplished through the formation of a tax-deductible reserve measured by the unrealized appreciation of the assets transferred.

If fixed assets are transferred to an industrialized country, the reserve must be "dissolved", i.e., restored to income beginning with the fifth year following the year in which it was formed, and over a period of not more than five years. In effect, payment of tax is deferred for a period of from five to ten years.

If assets are transferred to a developing country, the deferral is permanent. The statute provides that upon the transfer abroad of depreciable fixed assets, the net-book-value of the assets becomes the carrying value of the investment in the foreign subsidiary, provided that the transfer is made in connexion with the formation of the subsidiary or a substantial increase of its capital. The unrealized appreciation of the assets transferred becomes taxable when the investment is sold or liquidated. Since these rules are not applicable to foreign permanent establishments or foreign partnerships, tax deferral for investments of this kind is made dependent upon the condition that the assets transferred remain in the establishment or partnership for not less than three years.
After expiration of this time-limit, the deferral becomes a permanent exemption.

The tax benefits described above are reserved for foreign investments that serve the active conduct of a *bona fide* business. The statute requires that the foreign establishment or subsidiary be actively engaged in production or sale of merchandise, extraction of minerals, commercial services, or operation of an agricultural or forestry establishment. Rental or leasing of assets; licensing of patents, plans, designs or processes; or communication of know-how are considered an active conduct of a trade or business if the transferee is situated in a developing country.

Reserve for losses of foreign subsidiaries

A recent statute provides limited relief to parent firms in the Federal Republic for operating losses of their foreign subsidiaries. Unlike losses of domestic subsidiaries, which can be offset against income of the parent firm or another affiliated enterprise through an “integration” (*Organschaft*) arrangement, losses of a foreign subsidiary cannot be utilized by the parent firm under existing law except by a write-down of the investment in the subsidiary if the value of the latter is permanently impaired.

The relief takes the form of tax deferral through the formation of a deductible reserve which must be restored to income after five years or, under certain conditions, at an earlier time. A foreign subsidiary, for purposes of the provision discussed here, is a corporation domiciled in an industrialized country in which the parent firm holds a direct investment of at least 50 per cent of the capital stock, or a corporation domiciled in a developing country in which the parent firm holds a direct investment of at least 25 per cent.

Only those losses which are initial losses of the foreign subsidiary from the standpoint of the German investor qualify for relief. Thus, the reserve can be formed only for the year in which the taxpayer’s investment in the foreign subsidiary first reaches the required minimum of 50 per cent or 25 per cent, or exceeds that minimum if it had existed before, and for the following four years. In addition, the newly acquired shares must amount to not less than 5 per cent of the equity capital of the foreign corporation. The amount of the reserve is limited to that portion of the subsidiary’s loss which corresponds to the ratio of the newly acquired shares to the total share capital of the corporation. The reserve is further limited by the amount at which the investment in the foreign subsidiary is listed in the financial statements of the parent firm. In order for the domestic taxpayer to utilize this tax benefit, the foreign corporation must be actively engaged in a manufacturing, extractive, trading or agricultural business, and the loss must be computed under rules that are substantially similar to German tax-accounting principles. The statute lists additional requirements and certain situations in which the reserve must be prematurely dissolved. Once the investment reaches the level that justifies the formation of the reserve, not only the loss of the year in which the reserve is formed, but losses of the following four years are taken into consideration.

As indicated above, the tax benefit can be used only in connection with the acquisition of shares of a foreign corporation through which a certain minimum investment is either first established or increased. It offers no relief for operating losses of wholly owned subsidiaries or in other cases where the domestic taxpayer’s investment in a foreign corporation remains stationary. While the new relief measure is of interest as a first legislative attempt to permit some utilization of the losses of foreign subsidiaries, it is of limited usefulness as compared with the transfer of losses within an affiliated group of domestic corporations through the integration (*Organschaft*) device. In effect, the formation of the reserve permits deferral of the tax for five years. If it turns out that the value of the investment in the foreign subsidiary is permanently impaired, the taxpayer is entitled to write down the investment to its current going-concern value. If the conditions for this write-down are not present, the reserve must be restored to taxable income.

Losses of foreign establishment

As a general rule, losses sustained by a German business enterprise in a foreign permanent establishment can be offset against income from other sources, unless the establishment is situated in a country that has a tax treaty with the Federal Republic. In the latter case, the establishment is no longer subject to German tax jurisdiction, with the result that its losses, as well as its profits, are eliminated from the tax base of the enterprise. The statute changes this rule with respect to losses. Under the new provisions, losses of an establishment located in a treaty country can be deducted from other income of the enterprise to the extent that the loss exceeds the income, if any, from other establishments in the same foreign country. In so far as the loss deduction exceeds the taxpayer’s income from other sources during the same taxable year, the net operating loss can be carried forward to the following five years. The loss carry-over must be reduced by profits of later taxable years realized in the foreign establishment or other establishments in the same treaty country, unless the law of that country does not permit a loss carry-over to subsequent taxable years.

Specific tax incentives for investments in developing countries

Statutory tax incentives for certain investments in developing countries were first introduced in 1961 in the Federal Republic of Germany on an experimental basis. The tax benefits offered applied in the areas of taxes on individual and corporate income, trade tax and networth tax. The original rules were replaced, and considerably improved, by statutes of 1963 and 1968. The benefits extended by the statute of 1968 can be claimed by qualifying taxpayers as a matter of right. The qualifying investments in developing countries, the forms of capital transfer contemplated by the statute and the tax

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incentives that apply in the various situations are summarized below. These incentives are in no way dependent upon the method of taxation applied by the developing country.

**Qualifying investments**

The qualifying investments in developing countries are as follows:

(a) Investments in the equity capital of a corporation or other commercial entity that are made in connexion with the formation of the entity or an increase of its capital. This form of investment covers primarily existing or newly formed subsidiaries of corporate taxpayers in developing countries. Although a minimum investment is not required, the fact that the investment must be made in connexion with the formation of the entity or an increase of its capital rules out minor transfers.

(b) Investments in the assets of a branch or other dependent establishment of the taxpayer in a developing country, or in a partnership or other unincorporated association, made upon the formation of the branch or association or in connexion with a substantial expansion of its business.

(c) Loans in the nature of a capital investment made to a corporation or other commercial entity in a developing country in connexion with the formation of the entity or a substantial expansion of its business. The inclusion of loans in the catalogue of qualifying investments was motivated by the fact that substantial investments in the equity capital of corporations in developing countries are not always possible so that financing through debt capital must be substituted. The loan must be repaid entirely or in part within a period of six years and at least one of the following conditions must be met: (i) the lender owns directly or indirectly at least 15 per cent of the equity capital of the borrowing entity at the time the loan is made; (ii) the loan agreement provides for a participation in profits in lieu of interest; (iii) the borrower uses in its production, during the effective period of the loan, patents, copyrights, plans, designs, processes or know-how of the lender, or sells during the period goods bearing the lender’s trade mark.

In addition to the requirements listed above, the entity, association or establishment in the developing country must be engaged exclusively or almost exclusively in one of the following activities: the production or sale of merchandise; the extraction of natural resources; commercial services; or agriculture or forestry. The operation of merchant ships in international commerce also qualifies under certain conditions. This catalogue of qualifying activities excludes investments in foreign holding companies and speculative ventures.

**Forms of capital transfer**

The investment in the entity, association or establishment in the developing country can be made in the form of cash, depreciable fixed assets, land forming part of the fixed assets of a business or inventory items.

**Tax incentives**

The income-tax incentives available under the statute consist of an investment allowance for part of the investment, tax deferral through formation of an investment reserve for another part, and income-tax exemptions or tax deferral for gains realized in connexion with the transfer of assets to a developing country, or in connexion with unavoidable reorganizations or other dispositions of investments in such countries.

The investment allowance is a deduction from income in an amount not exceeding 15 per cent of the cost of the investment. It can be claimed for transfers of depreciable fixed assets or land, and it must be claimed for the business year of the investor in which the capital transfer is made.

The taxpayer can form a tax-deductible investment reserve for all capital transfers to developing countries, i.e., land, depreciable fixed assets, inventory items and cash for acquiring inventories or certain other items. In order to safeguard that transfers of current assets are not only of passing benefit to the transferee, transfers of inventories are considered only to the extent that their value exceeds the value at the end of the last preceding business year; for the same reason, cash that is transferred must be expended for the purchase of qualifying assets by the end of the year following that of the transfer.

The computation and size of the investment reserve vary, depending upon whether or not an investment allowance can also be claimed. If the 15 per cent investment allowance is available, the reserve can be formed in an amount not exceeding 50 per cent of the remaining cost, or 42.5 per cent of the total cost of the investment (50 per cent of 85 per cent). The aggregate tax benefit for the year of the capital transfer thus amounts to 57.5 per cent (15 per cent plus 42.5 per cent).

If the 15 per cent investment allowance cannot be claimed (primarily, if an inventory or cash to acquire inventory items was transferred), the reserve can be formed in an amount not exceeding 50 per cent of the full cost of the investment. The maximum amount is increased to 60 per cent if the investment is made in a partnership or other unincorporated association, or in an establishment of the taxpayer in a developing country that has a tax treaty with the Federal Republic. In the absence of this provision, a reserve could not be formed for such direct investments as are eliminated from the tax base for purposes of German taxes on income and capital.

The investment reserve must be dissolved through annual credits to income beginning with the sixth business year following the year for which the reserve was formed, and the annual credits must not be less than one sixth of the reserve. Thus, an investment reserve of 6 million Deutsche Marks (DM) formed in 1971 must be gradually transferred to income beginning with the year 1977, and the annual credits must be at least DM 1 million in each year from 1977 to 1982. The taxpayer is free to shorten the transfer period by crediting larger amounts to income in the earlier years. Unlike the investment allowance, which constitutes a permanent tax benefit, the investment reserve amounts to a temporary deferral of tax. In the event that the value of the investment is permanently impaired when the reserve must be credited to tax, the taxpayer can write down the investment to its current

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going-concern value and thus secure a permanent tax advantage.

The investment allowance and investment reserve are also considered for purposes of the net-worth tax and result in an annual saving of 1 per cent of the tax value of the investment, which may be quite substantial.

**Tax treaties**

Tax treaties are primarily devices for the avoidance or mitigation of double taxation; in addition, the are used by the industrialized countries to accomplish certain goals of economic policy. In either case, an industrialized country concluding a tax treaty will accept certain limitations on its tax jurisdiction.

In addition to the statutory devices for the avoidance of double taxation and the promotion of investments in developing countries, the treaties of these countries with the Federal Republic of Germany include three important relief provisions, as follows: (1) exclusion of certain foreign-source income from the tax base for purposes of German taxation; (2) exemption of dividends distributed by a foreign corporation or other commercial entity in which a German commercial entity holds a substantial participation; and (3) a tax-sparing credit. These measures are discussed below.

The Federal Republic currently has tax treaties with seven developing countries outside Europe: Argentina (1966); Ceylon (1962); India (1959); Iran (1968); Israel (1962); Pakistan (1958); and Thailand (1967).

**Exclusion of income and property from the tax base**

Exclusion of income (and of the property that is the source of the income) from the tax base is the ultimate tax relief which a country can grant. For this reason, the Federal Republic of Germany applies this tax benefit on a selective basis, i.e., by treaty, and only for income from investments involving an entrepreneurial or quasi-entrepreneurial risk. The exclusion method currently applies to profits of a foreign permanent establishment, to investments in foreign partnerships and other unincorporated associations; and—with considerable modification—to income from services rendered abroad or real property situated abroad.

Exclusion of income from the tax base does not imply that the excluded income is completely disregarded for German tax purposes. Although the income is not taxed, it is considered in computing the average tax rate on the non-exempt income. This reservation (called “exemption with progression” or Progressions-Vorbehalt) is included in numerous European tax treaties and is not peculiar to treaties concluded by the Federal Republic.8

Unlike the exclusion of certain income under treaties between the Federal Republic and industrialized countries, the exclusion applied under the treaties with developing countries is absolute, i.e., it is not dependent upon a certain level of taxation in the other country. Accordingly, the benefits of a tax holiday or a moderate tax rate in the developing country are fully preserved for the investor and not nullified by the industrialized country.

Apart from providing income-tax relief, the treaties also exempt the investment that is the source of the income from the German net-worth tax 10 and from the municipal trade tax on income and capital.11 As most countries outside the Federal Republic of Germany, including the developing countries, do not impose taxes of this kind, these exclusions amount to an additional tax benefit which would not be available under the foreign-tax credit system.

**Exemption of intercompany dividends**

The treaties of the Federal Republic of Germany with developing countries provide for an exemption from German income tax for dividends paid by a foreign corporation or other commercial entity if the recipient of the dividend is a German commercial entity owning at least 25 per cent of the share capital of the distributing entity. The treaty provision is an extension of the statutory exemption of intercompany dividends that are distributed by one domestic entity to another. The exemption of intercompany dividends under the tax treaties is, in fact, more favourable than the domestic exemption because in order to prevent affiliated domestic entities from shifting profits from one member of an affiliated group to another without ever paying tax at the full corporate rate and without making a distribution outside the group, the recipient domestic entity is liable for a supplementary tax (Nachsteuer) to the extent that it does not redistribute the dividend received to its own shareholders or members.12 The rate of the supplementary tax is 36 per cent, i.e., the difference between the prevailing corporate tax rate on distributed profits (15 per cent) and the rate on retained earnings (51 per cent).13 The supplementary tax does not apply to dividends received from foreign corporations because it is designed to prevent abuses of the “split” corporate tax rate, which is not imposed on those corporations.

The exemption of intercompany dividends under tax treaties presupposes that the foreign affiliate is engaged in an active business. This requirement is met if the activities of the affiliate consist exclusively or almost exclusively in the manufacture or sale of merchandise or other goods, the renting of property, the rendition of commercial services or the operation of a banking or insurance business. Investments in foreign holding companies or investment enterprises do not, as a rule, qualify.

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9 The net-worth tax is an annual tax, at the rate of 1 per cent on the assessed value of business enterprises that are subject to German tax jurisdiction.

10 The municipal trade tax is a twofold and, in some municipalities, a threefold tax on business profits, business capital and the payroll of the enterprise. The base of the trade tax on business profits is equal to that of the tax on individual or corporate income, with certain adjustments.

11 There is a presumption that a corporation or other commercial entity distributes its own profits first. Accordingly, the supplementary tax applies in most cases where an entity distributes a dividend received by it, except in the case of pure holding companies.

12 Including the surcharge of 3 per cent currently in effect, the rates are 15.45 per cent and 52.33 per cent.
Such investments, however, may qualify to the extent that the holding company or investment enterprise re-distributes a dividend from a second-tier operating subsidiary which is engaged in active business.

**Tax-sparing credit**

A number of tax treaties between the Federal Republic of Germany and developing countries use a tax-sparing credit in order to preserve the tax advantages offered by the developing country to the investor. The tax-sparing credit applies in so far as these treaties do not permit the exclusion of income from the tax base, i.e., to dividends that do not qualify for the exemption of inter-company dividends and to interest and royalties. The tax-sparing credit is granted for these types of investment income because they usually benefit from tax reduction or exemption in the developing country and the application of the foreign-tax credit in the creditor country would nullify this benefit.

The detailed rules of the tax-sparing credit and the conditions for its application vary under the different tax treaties with developing countries which cover a period of nine years (1958-1967). The tax-sparing credit was originally introduced as an experimental measure and technical differences of the credit provisions under the various treaties reflect the experience gained over this period and the different needs of the developing countries.

As may be seen in table 3, the tax-sparing credit is computed in the treaty with India (1959) as a percentage of the German tax, and in all subsequent conventions as a percentage of the income to which the withholding tax of the developing country applies. The latter system, which relates the tax-sparing credit, like the regular foreign-tax credit, to income, will also be applied in future treaties.

The Federal Republic of Germany expects that the foreign country will reduce the rates of its withholding taxes in consideration of the benefits it receives through the tax-sparing credit. For this reason, the more recent conventions limit the credit to the amount that the Government of the Federal Republic considers a fair withholding rate.

The treaty articles that include the rules on the tax-sparing credit do not specify the incentive laws of the developing country or impose any provisions to preclude an abuse of the credit. It appears that no such abuses have been observed and that there is no substance to the arguments against the tax-sparing credit that are based on this expectation.

**B. Relief methods under tax treaties exemption method**

**TREATIES BETWEEN DEVELOPED COUNTRIES**

Exemption of certain income under tax treaties between developed countries is considerably more frequent and comprehensive in scope than the use of this method under the statutory law of those countries. The exemption method is used primarily in treaties concluded by continental European countries, while Canada, Japan and the United Kingdom of Great Britain and Northern Ireland rely primarily or exclusively on the foreign-tax credit.

Where two countries applying the exemption method conclude a tax treaty, the use of the method amounts, in

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**Table 3. Tax-sparing credit under treaties between the Federal Republic of Germany and developing countries**

<table>
<thead>
<tr>
<th>Treaty country</th>
<th>Year</th>
<th>Dividends</th>
<th>Interest</th>
<th>Commercial royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>1966</td>
<td>Credit for 15 per cent of dividend</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Ceylon</td>
<td>1962</td>
<td>—</td>
<td>—</td>
<td>Credit for at least 75 per cent of German tax</td>
</tr>
<tr>
<td>India</td>
<td>1959</td>
<td>Credit for at least 75 per cent of German tax</td>
<td>Credit for at least 75 per cent of German tax</td>
<td>—</td>
</tr>
<tr>
<td>Iran</td>
<td>1968</td>
<td>Credit for 20 per cent of dividends</td>
<td>—</td>
<td>Credit for 10 per cent of royalties</td>
</tr>
<tr>
<td>Israel</td>
<td>1962</td>
<td>Credit for at least 25 per cent of dividends</td>
<td>Credit for at least 15 per cent of interest</td>
<td>—</td>
</tr>
<tr>
<td>Pakistan</td>
<td>1958</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Thailand</td>
<td>1967</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>United Arab Republic</td>
<td>1959</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

*Source: "Taxation of private investment in developing countries by the Federal Republic of Germany" (ST/SG/AC.8/R.31).*
effect, to a division of tax jurisdiction through which the areas of taxation covered by the treaty are assigned to one or the other country. As a general rule, the renunciation of tax jurisdiction over certain income, or income and capital, is absolute: the country forgoing its right to tax does so whether or not the other country chooses to exercise the tax jurisdiction assigned to it by the treaty (so-called "avoidance of double taxation in this").

Where a tax treaty is concluded between an exemption country and a credit country, each country usually applies its own rule; that is, the exemption country will exclude the income from the tax base, and the credit country will tax the income as if the convention had not come into effect, but will reduce its tax by that of the other treaty country, subject to its statutory rules concerning the scope and computation of the foreign-tax credit. If the exemption country does not exercise its right of taxation, the tax of the credit country applies to the full extent, so that instances in which income remains entirely tax-free in both countries are rare. In a comparatively large number of cases, the treaty credit is used by countries that do not apply this device in their statutory law, as discussed below.

Considering that the flow of investment between two developed countries entering into a tax treaty, while not of equal size, is of substantial magnitude in both directions, and that the tax rates of the two countries are not very different in most cases, the country granting an exemption in favour of certain income actually does not give up significantly more revenue than it would by applying the foreign-tax credit. On the other hand, it saves itself and its investors numerous complications and much unproductive work. Where the exemption method applies, the investor deals only with one tax jurisdiction.

14 See convention between Switzerland and the United States of America (1951):

Article XV

"(1) It is agreed that double taxation shall be avoided in the following manner:

(a) The United States, in determining its taxes specified in Article I of this Convention in the case of its citizens, residents or corporations, may, regardless of any other provision of this Convention, include in the basis upon which such taxes are imposed all items of income taxable under the revenue laws of the United States as if this Convention had not come into effect. The United States shall, however, subject to the provisions of section 131, Internal Revenue Code, as in effect on the date of the entry into force of this Convention, deduct from its taxes the amount of Swiss taxes specified in Article I of this Convention. . . ."

(b) Switzerland, in determining its taxes specified in Article I of this Convention in the case of its residents, corporations or other entities, shall exclude from the basis upon which such taxes are imposed such items of income as are dealt with in this Convention, derived from the United States and not exempt from, and not entitled to the reduced rate of, United States tax under this Convention; but in the case of a citizen of the United States resident in Switzerland there shall be excluded all items of income derived from the United States. Switzerland, however, reserves the right to take into account in the determination of the rate of its taxes also the income excluded as provided in this paragraph. . . ."


Both he and his Government are freed from the necessity of going through complex computations that are entirely useless if it is a foregone conclusion that the tax of the home country will be eliminated by the tax of the country in which the investment is made. The burden of engaging in protracted arguments concerning the proper allocation of income or expenses to one or the other country is removed. Most importantly, instances of double taxation are non-existent; whereas such instances are commonplace where the foreign-tax credit method prevails because of conflicting determinations made by the tax authorities of the investor's home country and those of the source country.

Recognizing this situation, a task force appointed by the President of the United States of America, to make long-term policy recommendations for the promotion of economic growth, unanimously recommended that the United States Treasury Department be authorized to allow a tax exemption for foreign business income derived from high-tax countries, subject to appropriate safeguards. According to the report, the Treasury Department would be permitted, upon a finding that the effective corporate-income tax rate of a foreign country was equal to at least 75 per cent of the highest statutory United States corporate tax rate, to designate such a country as a "full-tax country"; this designation could be made effective both prospectively and with respect to the undistributed earnings of past high-tax years.

Dividends received by a United States corporation from a subsidiary in a high-tax country would be eligible for exemption from all United States taxes if attributable to a year in which the foreign enterprise satisfied certain requirements with respect to the nature and source of its income. Similarly, exemption of income of foreign branches of United States corporations meeting the tests for foreign subsidiaries would be authorized, subject to such limitations as might be deemed necessary to prevent tax avoidance, as in the case where prior losses of the branch had been applied against domestic income of the corporation.

As concerns both foreign subsidiaries and branches, the exemption would apply only upon an election made by the taxpayer. Thus, a taxpayer receiving income eligible for exemption would have a choice between


17 In its report, the Task Force submits, in this connexion, that consideration might be given to the rules of United States tax law on income from sources in United States possessions, as given in the Internal Revenue Code (1954), sec. 931. In broad outline, a "possessions corporation" (i.e., a United States corporation operating predominantly in a United States possession or possessions) is exempt from United States tax if at least 80 per cent of its gross income is derived from sources within a possession and at least 50 per cent of such income is derived from the active conduct of a trade or business in a possession. For purposes of the exemption of dividends from full-tax countries, the requirement might be varied to the effect that at least 80 per cent of the gross income of the subsidiary must be derived from sources in one or more full-tax countries and 50 per cent thereof from the conduct of an active trade or business within such countries. The Task Force also recommends that more realistic source rules be considered for this purpose. Ibid., p. 45.
reporting such income as taxable and claiming credit for the foreign taxes paid thereon, or treating the income as exempt for United States tax purposes. Since the exemption would be available only on a country-by-country basis, it could not be claimed by taxpayers electing the use of the over-all limitation on the foreign-tax credit.\textsuperscript{18} Foreign taxes on income not entitled to exemption (such as withholding taxes on interest or royalties paid by foreign subsidiaries) would continue to be eligible for the foreign-tax credit, notwithstanding the fact that income from qualified subsidiaries and branches located in the same foreign country is treated as exempt. In conclusion, the Task Force states in its report that inasmuch as the proposed changes might lead to increased investment by United States corporations in foreign countries designated as full-tax countries, it would appear to be in order to request those countries to extend compensating benefits to the United States in exchange for such designation. To this end, the enabling statute might condition the designation of a foreign country as a full-tax country upon the conclusion of satisfactory treaty arrangements in fiscal matters of mutual concern. In the final analysis, therefore, the exemption of foreign-source income would have its legal basis in a bilateral tax treaty.

Under existing treaties between developed countries, the exemption method applies to income from certain investments or activities reflecting a relatively permanent engagement of the investor in the source country. These categories of income are: industrial or commercial profits derived through a permanent establishment in the host country; income from real property situated there; frequently, dividends from a substantial ("at least 25 per cent" or "greater than 25 per cent") participation in the share capital of a corporation of the other country; and, occasionally, income from independent personal services rendered in that country, with or without the use of a "fixed base" maintained there. In a number of instances, some of the activities or holdings described, but not all, give rise to an exemption; there also are variations as to the scope of the exemption. For example, the exemption of income from real property, while always applying to rentals, may or may not include mortgage interest and capital gains from the disposition of the property.

Apart from its obvious practical advantages, the exemption method also meets the requirement of the equal treatment of taxpayers. Equality of tax treatment in the investor's home country, which is considered the relevant consideration by the advocates of the credit method, is difficult to achieve because investments in industrialized countries and investments in developing countries are not comparable. There is, in most developing countries, no equivalent to the infrastructure of the industrially advanced countries in the matter of services, communications, skilled labour, banking facilities and so forth. Not only the risk of investing in a develop-

\footnotesize{\textsuperscript{18} Under the over-all limitation on the United States foreign-tax credit, all foreign income and all foreign taxes are aggregated, i.e., treated as if they were derived from, or paid to, one single foreign country. See United States of America, \textit{Internal Revenue Code}, sec. 904 (a) (2).}

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\textsuperscript{19} Denmark-Sweden (1958), art. 3 (1). See also treaties of the Federal Republic of Germany with Luxembourg (1959), art. 20; and with Norway (1959), art. 19; and Austria-Luxembourg (1962), art. 20.

\textsuperscript{20} Treaties of Denmark with Austria (1961), art. 19; and France (1957), art. 19 (1); Federal Republic of Germany-Greece (1966), art. XVII. The exemption usually takes the form of the "exemption with progression". Under the treaties concluded by Sweden, the exemption is subject to the further condition that the dividend would be exempt under Swedish law if the distributing enterprise were domiciled in Sweden. See treaties of Sweden with Federal Republic of Germany (1959), art. 19; and Switzerland (1965), art. 25.

\textsuperscript{21} See of Austria with Denmark (1961), art. 19 (director's fees and income of professional entertainers) and Luxembourg (1962), art. 20 (dividends, interest and royalties); Denmark-Federal Republic of Germany (1962), art. 19 (dividends other than intercompany dividends from a substantial participation).

\textsuperscript{22} Treaties of Spain with Norway (1963), art. 24 (foreign-tax credit for dividends, interest and royalties); and Switzerland (1966), art. 23 (on Spanish side, foreign-tax credit for interest, dividends and royalties; on Swiss side, and for the same types of income, foreign-tax credit, lump-sum reduction of Swiss tax or partial exemption of income, as shall be determined by Switzerland).

\textsuperscript{23} See the following treaties: (a) Federal Republic of Germany with Denmark (1962), art. 19 (dividends other than intercompany dividends from a substantial participation and certain remunerations and pensions paid from Irish public funds); Japan (1966), art. 23 (dividends other than intercompany dividends from a substantial participation, interest, royalties, income of public entertainers and remuneration from Japanese public funds); Netherlands (1959), art. 20 (dividends
TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Very few tax treaties between developed and developing countries assign the taxation of all income covered by the convention categorically to one or the other treaty country, so that there are no areas in which both countries retain tax jurisdiction with respect to the same class of income. The principal examples are the conventions of Sweden with Tunisia (1960) and Morocco (1961). Under these treaties, industrial, commercial, mining or financial profits of an enterprise are taxable only in the country in which its permanent establishment is located; if there are establishments in both countries, each is taxed on the basis of separate accounts maintained by it or, if no such accounts are maintained or if they are inadequate, on the basis of an apportionment (Sweden- Tunisia) or a reasonable percentage of the gross income realized by the establishment based on comparative figures (Sweden-Morocco). Income from immovable property, including profits from agriculture or forestry, is taxable in the country where the property producing the income is situated. Income from personal services, including professional services, is taxable where the services are performed. Income from loans, deposits or other forms of indebtedness is taxable at the creditor’s residence; similarly, income from securities is taxed where the beneficiary is domiciled. Intercompany dividends are exempt under the rules applying to domestic intercompany dividends, and director’s fees and similar compensation are taxable where the actual place of management of the enterprise is situated. All other income is taxable only in the State of which the beneficiary of the income is a resident. This system undoubtedly has the advantage of great simplicity and effective avoidance of double taxation. It is so rarely applied, however, that it is in no way representative of existing tax treaties between developed and developing countries.

This survey covers, in addition to the two Swedish conventions named, 32 treaties between developed and developing countries, of which 27 were concluded by the four Scandinavian countries and the Federal Republic of Germany. Under all these treaties, the exemption method applies to industrial or commercial profits derived through a permanent establishment in the other treaty country and to income from real property (as defined in the treaties) situated in that country.

Most treaties concluded by the Federal Republic of Germany exempt from German tax intercompany dividends from a "substantial" (in some cases, 25 per cent; other than intercompany dividends from a substantial participation and interest on convertible bonds and participating debentures); United States of America, art. XV (dividends other than intercompany dividends from a substantial participation and salaries or pensions paid from public funds of the United States or its subdivisions); (b) France with Italy (1965), art. 22 (dividends and interests); (c) Greece with Sweden (1961), art. XXIII (dividends, interest and royalty); (d) Ireland with Switzerland (1966), art. 22 (foreign-tax credit, lump-sum reduction of Swiss tax or partial exemption from Swiss tax on dividends, as shall be determined by Switzerland); (e) Luxembourg with United Kingdom (1967), art. XXV (dividends other than intercompany dividends from a substantial participation); (f) Norway with Canada (1960), art. XXII (dividends, interest, royalties and income from estates or trusts); and Japan (1967), art. 23 (dividends, interest and royalties).

In others, more than 25 per cent) participation in the equity capital of a corporation of the other treaty country, Five of the treaties concluded by Sweden exempt all dividends from sources in the other treaty country and (except for the treaty with Pakistan), regardless of the characteristics of the shareholder and the relative size of the investment; while other treaties make the exemption of intercompany dividends dependent upon compliance with the conditions under which domestic intercompany dividends are exempt under Swedish law. In the case of dividends that do not qualify under this rule, Sweden grants the foreign-tax credit; and, in a few cases, a tax-sparking credit for the tax of the source country. Among the Danish conventions, one provides for exemption of dividends at the shareholder’s residence, while two permit both countries to tax the dividend, and another eliminates the taxes of the source country other than those imposed on the distributing corporation. Of the treaties concluded by Finland, one exempts dividends from the tax of the shareholder’s home country, while two others permit both countries to tax this income.

Exemption of dividends at the shareholder’s residence is provided for in two treaties concluded by Norway, while under two others, both countries are entitled to tax, and another eliminates the withholding tax of the source country.

Interest is exempt from the tax of the creditor’s country of residence, regardless of the nature of the interest-bearing debt, under four treaties concluded by Sweden, and under three treaties of India. All other conventions maintain the tax jurisdiction of both countries with respect to this income, with the creditor’s country of residence granting a foreign-tax credit for the withholding tax of the source country.

24 Treaties of Sweden with Argentina (1962), art. V; India (1958), art. VIII; Pakistan (1959), art. VI (2); Peru (1966), art. VI; and Thailand (1961), art. VI (1). The last-named treaty limits the tax of the source country on intercompany dividends to 20 per cent, provided that the parent firm owns more than 25 per cent of the voting stock of the subsidiary.

25 Treaties of Sweden with Brazil (1965), art. III (2); Greece (1961), art. VII (3); India (1958), art. VIII; Israel (1959), art. VI (3); and the Philippines (1966), art. VI (4).

26 Currently, dividends received by a Swedish corporation from another Swedish corporation are, as a rule, not subject to tax. The exemption cannot be claimed by banks or other financial institutions, or by closely held companies which fail to make adequate dividend distributions to their own shareholders.

27 Denmark-Israel (1959), art. VIII.

28 Treaties of Denmark with Israel (1960), art. 10; and Thailand (1965), art. 10.

29 Denmark-Ceylon (1963), art. VI.

30 Finland-India (1961), art. IX.

31 Treaties of Finland with Israel (1965), art. 10; and United Arab Republic (1965), art. 10.

32 Treaties of Norway with India (1959), art. XVII; and Thailand (1964), art. 23.

33 Treaties of Norway with Israel (1966), art. 10; and United Arab Republic (1964), art. 10.

34 Norway-Singapore (1966), art. VII.

35 Treaties of Sweden with Argentina (1962), art. VI; India (1958), art. IX; Peru (1966), art. VII; and Thailand (1961), art. VII.

36 Treaties of India with Denmark (1959), art. IX; Finland (1961), art. X; and Norway (1959), art. IX.

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Summarized below are the items of income for which capital-exporting countries that otherwise use exemption of income as the primary treaty relief method grant the foreign-tax credit for the tax of the source country.

**Table 4. Items of Income for Which Capital-Exporting Countries Grant Foreign-Tax Credit for Tax of Source Country**

<table>
<thead>
<tr>
<th>Treaty country</th>
<th>Year of treaty</th>
<th>Items for which foreign-tax credit is granted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria-United Arab Republic</td>
<td>1962</td>
<td>Dividends, interest, cinematograph film rentals and film royalties.</td>
</tr>
<tr>
<td>Denmark-Ceylon</td>
<td>1963</td>
<td>Profits from operation of ships or aircraft. Source-country tax reduced by 50 per cent (art. V).</td>
</tr>
<tr>
<td>Denmark-India</td>
<td>1959</td>
<td>Profits from operation of ships. Source-country tax reduced by 50 per cent (art. VI).</td>
</tr>
<tr>
<td>Denmark-Thailand</td>
<td>1965</td>
<td>Profits from operation of ships. Source-country tax reduced by 50 per cent (art. 8); royalties and gain from alienation of royalty-producing property or right (art. 12).</td>
</tr>
<tr>
<td>Federal Republic of Germany-Argentina</td>
<td>1966</td>
<td>Dividends other than intercompany dividends from a substantial (at least 25 per cent) participation, interest, royalties and directors' fees. Tax-sparing credit for dividends, interest and royalties.</td>
</tr>
<tr>
<td>Federal Republic of Germany-Ceylon</td>
<td>1962</td>
<td>Dividends other than intercompany dividends from a substantial (at least 25 per cent) participation, royalties, interest other than mortgage interest, profits from operation of ships or aircraft, and remuneration (including pensions) paid from Ceylonese public funds. Tax-sparing credit for royalties.</td>
</tr>
<tr>
<td>Federal Republic of Germany-India</td>
<td>1959</td>
<td>Dividends other than intercompany dividends from a substantial (more than 25 per cent) participation, interest, shipping profits, and remuneration paid from Indian public funds. Tax-sparing credit for dividends and interest (art. XVI).</td>
</tr>
<tr>
<td>Federal Republic of Germany-Iran</td>
<td>1968</td>
<td>Dividends other than intercompany dividends from a substantial (at least 25 per cent) participation, interest, royalties and remuneration (including pensions) paid from Iranian public funds. Tax-sparing credit for dividends and royalties (art. 24).</td>
</tr>
<tr>
<td>Federal Republic of Germany-Israel</td>
<td>1962</td>
<td>Dividends other than intercompany dividends from a substantial (at least 25 per cent) participation (provided distributing corporation is engaged in certain business activities), interest, royalties and similar payments, and compensation paid from Israeli public funds. Tax-sparing credit for dividends and interest.</td>
</tr>
<tr>
<td>Federal Republic of Germany-Pakistan</td>
<td>1958/1963</td>
<td>Dividends other than intercompany dividends from a substantial (at least 25 per cent) participation, interest, and remuneration, including pensions paid from Pakistani public funds (art. XIV). Tax-sparing credit for interest.</td>
</tr>
<tr>
<td>Federal Republic of Germany-Thailand</td>
<td>1967</td>
<td>Dividends other than intercompany dividends from a substantial (at least 25 per cent) participation, shipping profits, interest, royalties and gain from alienation of the royalty-producing property or right, profits from providing services of public entertainers and certain remuneration paid from Thai public funds.</td>
</tr>
<tr>
<td>Federal Republic of Germany-United Arab Republic (Egypt)</td>
<td>1959</td>
<td>Dividends and interest (art. VIII).</td>
</tr>
<tr>
<td>Finland-India</td>
<td>1961</td>
<td>Profit from operation of ships. Source-country tax reduced by 50 per cent (art. VI).</td>
</tr>
<tr>
<td>Finland-Israel</td>
<td>1965</td>
<td>Dividends, interest, and royalties (arts. 10, 11, 12 and 23). Tax-sparing credit for dividends and interest.</td>
</tr>
<tr>
<td>Finland-United Arab Republic</td>
<td>1965</td>
<td>Dividends, interest and royalties (arts. 10, 11, 12 and 23).</td>
</tr>
<tr>
<td>France-Israel</td>
<td>1963</td>
<td>Certain income from securities, interest and royalties.</td>
</tr>
<tr>
<td>France-Lebanon</td>
<td>1962</td>
<td>Royalties, directors' fees, compensation for independent personal services and income of public entertainers.</td>
</tr>
<tr>
<td>Norway-India</td>
<td>1959</td>
<td>Profit from operation of ships. Source-country tax reduced by 50 per cent (art. VI).</td>
</tr>
</tbody>
</table>
The tax-sparing credit

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 \textit{Ad Hoc} Group of Experts prepared for its first meeting.\textsuperscript{37} The purpose of the present study is a more detailed examination of the manner in which the tax-sparing credit is applied under conventions between developed and developing countries.

Scope of application

As an extension of the regular foreign-tax credit, the tax-sparing credit can be applied either to taxes on all income derived from sources in a developing country for which the capital-exporting country otherwise grants the regular credit, or to taxes of the developing country imposed on certain selected types of income. The first group of treaties includes six conventions between the United Kingdom and developing countries\textsuperscript{38} and a number of others.\textsuperscript{39} Under these treaties, the tax-sparing credit can be claimed for the tax of the developing country on income from direct business operations conducted in its territory through a branch or other establishment. The second and somewhat larger group of treaties limits the application of the credit to withholding taxes on investment income—dividends,\textsuperscript{40} interest and royalties. The coverage of these treaties shows considerable variations.

These differences are reflected in the data contained in table 5, which point up how little uniformity there is both among treaties concluded by different capital-exporting countries as well as among the treaties of one and the same country. In order to appreciate these differences, it must be borne in mind that tax-sparing is a very recent development—the first treaties containing a tax-sparing clause were concluded in the late 1950s—and that countries negotiating a tax treaty have experimented with various forms of this novel device. In addition, different preferences of the developing countries concerning the application of the credit to various classes of income, as well as reciprocal concessions made in the course of treaty negotiations, may account for some of the differences.

\textsuperscript{37} \textit{Tax Treaties between Developed and Developing Countries} (United Nations publication, Sales No. E.9.XVI.2), part two, paras. 24-34.

\textsuperscript{38} \textit{Treaties of United Kingdom with Israel (1962), Jamaica (1963), Malta (1962), Pakistan (1961), Portugal (1968) and Singapore (1966).}

\textsuperscript{39} Denmark-Philippines (1966); Greece-Italy (1965) (reciprocal tax-sparing provisions); treaties of Japan with Federation of Malaya (1963), India (1963) and Thailand (1963); and of Sweden with Brazil (1965), Israel (1959) and Philippines (1966).

\textsuperscript{40} See treaties of: (a) Denmark with Israel (1966), art. 23 (2); and Philippines (1966), art. XXIII (5); (b) Federal Republic of Germany with Argentina (1966), art. 20 (1) (b) (3); Greece (1966), art. XVIII (2) (a) (b); Iran (1968), art. 24 (1) (c); and Israel (1962), art. 18 (1) (c); (c) France with Israel (1963), art. 20 B4; and Spain (1963), art. 28 A 4b; (d) Japan with Brazil (1967), art. 22; India (1960), art. XI (3); and Singapore (1961), art. XIV (3) (b); (e) treaties of United Kingdom referred to in foot-note 38.


TABLE 5. TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES PERMITTING A TAX-SPARING CREDIT

<table>
<thead>
<tr>
<th>Developed country</th>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>India (1959)</td>
<td>India</td>
<td>India (1966)</td>
</tr>
<tr>
<td></td>
<td>Iran (1968)</td>
<td>Iran</td>
<td>Iran (1968)</td>
</tr>
<tr>
<td>France ............</td>
<td>Brazil (1967)</td>
<td>Brazil</td>
<td>Brazil (1967)</td>
</tr>
<tr>
<td></td>
<td>Israel (1959)</td>
<td>Israel</td>
<td>Israel (1959)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>United Kingdom ...</td>
<td>Israel (1962)</td>
<td>Israel</td>
<td>Israel (1962)</td>
</tr>
<tr>
<td></td>
<td>Jamaica (1965)</td>
<td>Jamaica</td>
<td>Australia (1965)</td>
</tr>
<tr>
<td></td>
<td>Portugal (1968)</td>
<td>Portugal</td>
<td>Portugal (1968)</td>
</tr>
</tbody>
</table>

* Subject to limitations.

References. Of the treaties examined, 20 permit a tax-sparing credit for the tax of the source country on dividends; 23 for the tax on interest; and at least 10 for the tax on royalties, which term is usually defined in the treaties as including fees for technical assistance or the communication of know-how.

Conditions and limitations

As a special form of exemption from the tax of the capital-exporting country, the tax-sparing credit is a relief measure which that country extends to those of its residents and enterprises which invest in developing countries, but not to other taxpayers. It is thus incumbent upon the capital-exporting country to see to it that the intended limits of the tax benefit are strictly observed. Accordingly, all treaties containing a tax-sparing clause include certain conditions and limitations directed at possible abuses. These restrictions are directed to the developing countries, rather than to the investor, who has little choice in the matter. Perhaps the most significant control measure applied in the treaties is the identification of the incentive legislation of the developing country on which the exemptions or rate reductions offered by it are based. A number of treaties containing a tax-sparing provision describe this legislation in very general terms, while others name the incentive statutes of the developing country.

A typical treaty clause describing the incentive-tax legislation of the source country in rather general terms may read as follows: "Taxes which have been relieved or reduced in one of the Contracting States by virtue of the national law of that Contracting State for a limited period of time." 41

One treaty concluded by Brazil cites, among the Brazilian statutes for which relief will be given, "the special incentive measures designed to promote economic development in the Amazonian Region and the Northern and Northeastern Regions of Brazil." 42 Similarly, another treaty provides, in effect, that the tax-sparing provision shall also apply for a period not exceeding 10 years where the Brazilian tax has been relieved or reduced under a programme of economic development. 43

41 Denmark-Philippines (1966), art. XXIII (5).
42 Brazil-Japan (1967), art. 22 (2).
43 Brazil-Sweden (1965), art. II (3).
There are several other conventions in this class.\textsuperscript{44} A representative example of precise identification of the incentive legislation of the developing country is the language used in the treaty between France and Israel (1963):

"For the purpose of effecting the credit referred to, interest exempted from Israeli tax under article 47A of the Israel Encouragement of Capital Investments Law 5719-1959, as amended, shall be deemed to have been actually taxed in Israel as provided in article 10, paragraph 2, of this Convention."\textsuperscript{45}

Similar language is used in a number of other treaties.\textsuperscript{46} Many treaties restrict the application of the tax-sparing credit to exemptions or rate reductions under incentive laws of the developing country that were in effect on the date when the convention was signed and not modified thereafter, or modified only in minor respects so as not to affect the general character of this legislation.\textsuperscript{47}

Another method designed to limit the tax-sparing credit to relief under legislation of the developing country that is acceptable to the capital-exporting country is to consider only those statutes whose application is agreed upon between the capital-exporting country and the developing country. Thus, the convention between Japan and Zambia refers to: "the special incentive measures designed to promote economic development in Zambia, provided that an agreement is made between the Governments of both Contracting States in respect of the scope of such special incentive measures."\textsuperscript{48}

Similarly, the convention between the Federal Republic of Germany and Israel requires that relief from Israeli tax on dividends and interest be based on "provisions of Israeli tax law specified by mutual agreement between the Contracting Parties."\textsuperscript{49}

The relief measures extended by developing countries should be, and in most cases are, designed to assist a new enterprise during the initial period of operations and not to act as a permanent subsidy. For this reason, a considerable number of treaties specify that the tax-sparing credit can be claimed for exemptions or rate reductions which the developing country grants "for a limited period.

\textsuperscript{44} See Denmark-Israel (1966), art. 23 (2); Greece-Italy (1965), art. 22 (2), in which tax-sparing provisions are reciprocal; Norway-Israel (1966), art. 23; and treaties of Sweden with Argentina (1962), art. VII (4), which applies only to royalties; Greece (1961), art. XXIII; Israel (1959), art. XVII (2) (a); and Thailand (1961), art. VIII (4).

\textsuperscript{45} France-Israel (1963), art. 20 B4.

\textsuperscript{46} See treaties of: (a) France-Spain (1963), art. 28A 4(b); (b) Japan with Brazil (1967), art. 22 (2); Federation of Malaysia (1963), art. XIV (3); India (1960), art. XI (3) (b); Singapore (1961), art. XIV (3) (b); and Thailand (1963), art. XIV (2) (b); (c) Norway-Singapore (1963), art. XVII (4) (a); (d) United Kingdom with Israel (1962), art. XVIII; Jamaica (1965), art. XVIII (2) (a); Malaysia (1963/1967), art. XVIII (4); Malta (1962), art. 13; Pakistan (1961), art. XIV (2); Portugal (1968), art. 22 (2); and Singapore (1966), art. 18 (4).

\textsuperscript{47} See treaties of Japan with India (1960), art. XI (3) (b); and Thailand (1963), art. XIV (2) (b).

\textsuperscript{48} Japan-Zambia (1970), art. 22 (2) (c) (ii). To the same effect is the treaty between Japan and the Republic of Korea (1970), art. 18 (3) (b).

\textsuperscript{49} Federal Republic of Germany-Israel (1962), art. 18 (1) (c). See also Federal Republic of Germany-Iran (1968), art. 24 (1) (c). of time."\textsuperscript{50} A few treaties go beyond this somewhat general formulation and set a definite time limit on the operation of the tax-sparing credit.\textsuperscript{51}

In order to prevent that every change in the incentive tax legislation of the developing country makes necessary a renegotiation of the treaty, a number of conventions define the conditions under which future legislation shall be deemed to be covered by the treaty. To this end, the following formula is used in several treaties concluded by the United Kingdom:

"Any other provision which may subsequently be made, granting an exemption which is agreed by the taxation authorities of the Contracting Parties to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character."\textsuperscript{52}

The conditions for qualification of future incentive legislation of the developing country are thus quite similar to those in reference to modification of legislation that existed at the time the convention became effective.

Methods of computing the credit

The tax-sparing credit has been computed in various ways: in terms of the income for which the developing country grants an exemption or rate reduction; in terms of the tax of the capital-exporting country; or through various combinations of these methods, each of which will lead to a somewhat different result. Relating the credit to income reflects the thought that the tax-sparing credit is merely a variation of the regular foreign-tax credit. As in the case of the latter, a percentage of income (e.g., 15 per cent of interest) is applied against the tax of the investor’s home country. The advantage of this method is that the amount of the credit does not vary in proportion to the tax of the capital-exporting country. It is the method most frequently applied under treaties containing a tax-sparing clause.

If the tax-sparing credit is related to the tax of the investor’s country of residence, the investor is, in effect, guaranteed a minimum credit in the event that the tax rate of the developing country is reduced to a figure below the guaranteed rate. An example of this method of computing the tax-sparing credit is the treaty between the Federal Republic of Germany and India (1959), under which the German foreign-tax credit for Indian taxes on

\textsuperscript{50} See among others, Denmark-Israel (1966); treaties of Federal Republic of Germany with Argentina (1966) (royalties only); and Israel (1962); Italy-Greece (1965) (no time limitation for taxes on interest); Norway-Israel (1966); and treaties of Sweden with Argentina (1962), Israel (1959) and Thailand (1961).

\textsuperscript{51} Brazil-Sweden (1965), in which art. II (3) states: "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 program of economic development:" and United Kingdom-Portugal (1968), in which art. 22 (2) (b) states: "... relief from United Kingdom tax shall not be given ... in respect of income from any source if the income arises in a period starting more than ten years after the exemption from, or reduction of, Portuguese tax was first granted in respect of that source.

\textsuperscript{52} Treaties of United Kingdom with Israel (1962), art. XVII (2) (b); Jamaica (1965), art. XVII (2) (b); Malaysia (1963/1967), art. XVIII (4) (a); Pakistan (1961), art. XIV (2) (b); Portugal (1968), art. 22 (2) (b); and Singapore (1966), art. 18 (4) (a).
dividends and interest shall be the amount of those taxes, but not less than 50 per cent of the Federal Republic tax. Similariy, the treaty with Ceylon (1962) permits a German licensor to claim credit for the Ceylonese tax on the royalties, but in any case not less than 75 per cent of the Federal Republic tax. It may be seen that this relief method—which is not used in recent conventions between the Federal Republic of Germany and developing countries—is in no way dependent upon exemptions or rate reductions in the developing country and is not, therefore, strictly a tax-sparing credit.

An example of a treaty provision combining several of the methods discussed is the tax-sparing clause of the convention between the Federal Republic of Germany and Pakistan (1963 Protocol), which limits the credit for exempted interest to one-half of the Federal Republic tax, but not less than 20 per cent of the interest, with the usual proviso that the amount of the credit shall not exceed the Pakistani tax that would have been payable if the treaty exemption had not been granted.

Intercompany dividends and "deemed-paid" tax-sparing credits

There is no need for a tax-sparing credit in so far as intercompany dividends distributed by a corporation of a developing country are fully exempt from the tax of the capital-exporting country, as discussed above. Occasionally, intercompany dividends are disqualified for other reasons, e.g., because the corporation in the developing country is a holding company of a special type of holding company.

A number of treaties concluded with developing countries by Japan and the United Kingdom include, in addition to the "direct" foreign-tax credit for withholding taxes of the source country on dividends, an indirect or "deemed-paid" foreign-tax credit, i.e., a credit for the tax that the developing country corporation would have been obliged to pay but for the full or partial exemption extended to it by the incentive legislation of its country of domicile. The amount of this credit is determined by the proportion which the dividend is of the earnings and profits of the distributing corporation.

A deemed-paid tax-sparing credit is included in several treaties concluded by Japan. The credit can be claimed only by corporate shareholders owning a certain percentage of the stock of the distributing corporation. This minimum holding is 10 per cent under the Japan-Ceylon treaty, 25 per cent of the voting stock of the corporation in the other treaty country under the treaties of Japan with the Federation of Malaya and Thailand, and 25 per cent of the "shares or capital" of the distributing corporation under the treaty between Zambia and Japan. The deemed-paid tax-sparing credit is specifically excluded under the treaty between Japan and Singapore (1961).

Some treaties concluded by the United Kingdom limit the deemed-paid tax-sparing credit to corporate shareholders that are resident in the United Kingdom and control directly or indirectly at least 10 per cent of the voting stock of the distributing corporation in the other treaty country. These restrictions are not included in two other treaties of the United Kingdom, which incorporate, by reference, the law of the United Kingdom concerning the foreign-tax credit. While it is clear that no minimum holding is required under the latter treaties in the case of corporate shareholders, there may be a question whether individual shareholders could claim this credit. Since the treaty articles referred to do not restrict the application of the foreign-tax credit to the law of the United Kingdom as it existed at the time the treaties became effective, the better view appears to be that changes in the foreign-tax credit rules must be given effect. Under current United Kingdom statutes—unlike those which were in effect at the time the treaties with Malaysia and Pakistan were signed—individual residents of the United Kingdom cannot claim a deemed-paid foreign-tax credit.

Where the capital-exporting country grants a deemed-paid tax-sparing credit in addition to the direct credit, the tax effects of operating through a subsidiary formed under the law of the developing country are fully equalized with those which prevail in the case of direct business operations through a branch or other unincorporated establishment. Under these rules, the choice of the form of operation is no longer influenced by tax considerations. It has been frequently pointed out that operations through a local subsidiary shield the profits of that enterprise from taxation by the country of residence of the parent firm as long as the profits are not distributed as a dividend. If a distribution is made, however, the allowance of a deemed-paid tax-sparing credit puts the shareholder in exactly the same position he would be in if the foreign country had not granted an exemption or tax holiday. The allowance of this credit thus goes far beyond the mere insulation of the undistributed profits of the foreign corporation and accomplishes full recognition of the tax benefits extended by the developing country.

59 Federal Republic of Germany-India (1959), art. XVI (3) (b).
60 Federal Republic of Germany-Ceylon (1962), art. XV.
61 Federal Republic of Germany-Pakistan (1963 Protocol), treaty article XIV (3) (b) (dd).
62 See Federal Republic of Germany-Israel (1962), art. 18 (1) (c) and (g). There is no German tax-sparing credit for dividends distributed by an Israeli corporation in which 50 per cent or more of the assets consists of shares of corporations having their place of management outside Israel.
63 If, for example, the distribution is 50 per cent of earnings and profits, 50 per cent of the corporate income tax paid by the foreign corporation is creditable.
64 Treaties of Japan with Ceylon (1967), art. XV (2); Federation of Malaya (1963), art. XIV (3) (a); Thailand (1963), art. XIV (2) (a); and Zambia (1970), art. 22 (3) (b).
65 Treaties of the United Kingdom with Israel (1962), art. XVIII (1) (b); Jamaica (1965), art. XVIII (1) (b); and Singapore (1966), art. 18 (3) (c).
66 Treaties of the United Kingdom with Malaysia (1963/1967), art. XVIII (3); and Pakistan (1961), art. XIV (1).
67 See Tax Treaties between Developed and Developing Countries, part two, para. 33.
VIII. TAX INCENTIVES FOR REINVESTMENT*

A. The role of reinvestment

Most developing countries urgently need expanded industrial and commercial enterprise to contribute to their general economic development. The levelling-off in recent years of direct governmental assistance by developed countries has placed increasing emphasis on measures to expand private direct investment in developing countries. Tax factors are only one of a great variety of considerations affecting the flow of private capital to developing countries. These considerations include factors external to the host country, such as the policies of capital-exporting countries towards investment in developing countries, as well as internal factors, which are generally summarized under the heading "investment climate". The investment climate is affected by the availability of markets, raw materials, labour and other resources, political, monetary and financial conditions, and a host of other factors. As taxation, unlike most factors affecting investment, is largely controllable by legislation and by international agreements, its effects on investment deserve particular attention.

This study is concerned with the effect of various tax measures upon reinvestment by foreign investors. Reinvestment is of concern to developing countries for both economic and monetary reasons. Reinvestment increases the investor's contribution to the general level of capital formation in the host country. Since the management of an enterprise in a position to reinvest is already familiar with conditions in the host country, reinvestment can lead to unusually productive economic activity. Thus, reinvestment may be even more desirable than new investment to the extent it reflects more experienced economic judgements.

Equally important, reinvestment in the case of foreign investors defers a call upon the typically scarce foreign exchange reserves of the host country. While the enterprise in which the foreign investor participates may be useful in the economic development of the host country, the foreign exchange cost of the remittance of earnings from that investment may even outweigh the longer term economic benefits to be derived. The foreign exchange loss may be particularly difficult to bear where the foreign-owned enterprise is engaged principally in local transactions and does not "pay its way" through hard-currency export earnings to balance its profit remittances.

Reinvestment by foreign investors, however, like foreign investment in general, is not always an unmixed blessing. To the extent that it results in concentration of wealth and productive power in foreign hands, it may be seen as undesirable from the point of view of the over-all political, social and economic development of the host country. Some developing countries might prefer to have foreign capital function primarily as "seed" capital to be repatriated and replaced by local ownership as new industries become more solidly established.1

As reinvestment increases both the total contribution of a foreign investor to the economic development of the host country and the extent of concentration of wealth and economic power in foreign hands, developing countries must balance a variety of considerations in arriving at policies relating to reinvestment that are appropriate for their circumstances. As a rule, however, countries that welcome new foreign direct investment also seek to encourage reinvestment as a way of maximizing the total benefits to be derived from the influx of foreign capital.

The foreign investor, himself, is presumed to want to remit his earnings and capital to his home country sooner or later. His decision as to whether to reinvest or to withdraw earnings at any particular point in time usually involves a weighing of, first, the relative profitability of further investment opportunities in the host country, as compared with those elsewhere; and, secondly, the relative costs and burdens of reinvesting in the host country, as compared with withdrawing funds to reinvest them elsewhere. In both these comparisons, tax factors are likely to be of considerable importance.

It is important, however, to recognize that tax factors are basically secondary considerations for the investor. For tax incentives to be effective, the investor must be reasonably assured of the prospects of operating profitably. An investor will not be responsive to tax incentives in making a reinvestment decision unless he has confidence that he is secure from expropriation or subsequent non-convertibility of his earnings.

The problem for a developing country in selecting appropriate tax policies for encouraging reinvestment by foreign investors is complicated by the presence of at least one other party in interest, namely, the investor's home country. If the only parties involved were the investor and the host country, the latter could fashion tax policies to encourage reinvestment with relative simplicity and some assurance as to their economic effect. But the interaction between the tax systems of capital-exporting countries and that of the host country may impede or frustrate

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1 For example, a law recently enacted in Peru requires foreign-owned enterprises to sell at least 51 per cent of their capital to Peruvians after the investors have recouped their investment and earned a reasonable profit.

* In the preparation of this chapter, the United Nations Secretariat had the assistance of Stanford G. Ross and Carl J. Grun, attorneys, Caplin and Drysdale, Washington, D.C.
the policies of the host country. Most importantly, the multiplicity of tax systems often makes it difficult for the host country to accommodate its laws to the needs of all foreign investors or even to know the ultimate effects of its policies.

The problem is further complicated because so much of international investment is undertaken by multinational business organizations which have bases in a number of countries. Through the use of base enterprises, multinational business organizations may themselves largely determine the ultimate tax effects of the policies of the host country.

Examined below are the problems of interaction between the tax systems of capital-exporting countries and those of the host countries, and the measures that might be adopted either unilaterally, or through treaties, to accommodate those differences. At this point, however, establishing a few basic concepts is necessary to refine the analysis.

The word "reinvestment", as used in this study, usually means the reinvestment of earnings derived from an enterprise in a developing country in the same developing country, though not necessarily in the same business. Where a locally incorporated subsidiary is used, reinvestment is usually made by the subsidiary rather than by the shareholders, because in order for the latter to receive the earnings, a "withdrawal" would have to be made, with the likely imposition of dividend taxes. Such a course of action is so obviously disadvantageous that one may assume for practical purposes that reinvestment by foreign investors would be from retained earnings.

While reinvestment requires retention of earnings, it should be stressed, however, that the reverse is not necessarily true. Earnings may be retained simply to avoid or defer taxes or may be used in ways that are not economically productive. Thus, retention, as such, does not necessarily carry with it the benefits for the host country that come from productive reinvestment.

For a developing country, the practical distinction between retention and reinvestment may be less significant than it is for a more developed economy. The shortage of capital, high interest rates and the relatively low personal-income tax rates typical of developing countries may combine to reduce the likelihood that accumulated earnings will be kept completely idle. While the uses to which such funds are put may not be optimally productive from the point of view of the priorities of the developing country, even marginal uses are probably preferable to remittance of the funds abroad. From a monetary perspective, retention of any nature is beneficial to the extent that it defers calls on foreign exchange for dividend remittances. Nevertheless, to the extent that the tax system can influence or direct retained earnings into optimally productive reinvestment, it is obviously desirable to do so.

Lastly, what appears in some cases to be "reinvestment" is actually in the nature of "boot-strapping". Thus, the investor may take advantage of anticipated tax-free earnings to use a higher ratio of debt than he would in the absence of a tax holiday, with the intention of retiring the debt out of such earnings. While some boot-strapping is probably prudent planning on the part of the investor, the "reinvestment" that it involves is merely a substitute for initial investment. Such reinvestment requires no special incentives as it is reinvestment that the investor's basic strategy requires him to make.

The major features of the tax systems of the developing countries and of the capital-exporting countries which impinge upon the reinvestment decision are examined below.

B. Tax treatment of dividends as affecting reinvestment

The alternative to retention is the withdrawal of earnings through dividend distributions. Accordingly, it is necessary to consider the way in which dividends are taxed in host countries and in capital-exporting countries. From the standpoint of the investor, the interaction of the two systems determines his net after-tax profits.

Corporate-shareholder taxation in host countries

Types of systems

Although the principal focus of this study is on tax measures affecting reinvestment by foreign investors, consideration of the varieties of tax treatment in general of corporations and their shareholders in host countries is required properly to frame the issues. Foreign investors are usually treated the same as domestic investors, and such differences as do exist can best be evaluated against the background of the normally applicable rules.

The relative tax costs of retention versus withdrawal of earnings are largely influenced by the relationship between taxes on corporate income and on individual income. At one end of the spectrum is a system that essentially ignores the corporate entity and imposes no corporate-income tax, but only personal-income taxes on shareholders for their pro rata share of corporate profits. Such a system, which corresponds to the pattern of partnership taxation in many countries, places a severe tax disadvantage on retaining earnings in the corporation, since shareholders are thereby taxed on income that they do not actually receive. Although infrequently encountered, this kind of system, from the standpoint of reinvestment, is closely akin in concept to the so-called "fully integrated" systems discussed below.

In contrast, some so-called "two-tier" tax systems tax earnings first at the corporate level and again upon distribution to shareholders, without any allowance for the corporate tax. Separate taxation of corporations and shareholders provides built-in encouragement to retain earnings in the corporation in order to defer tax on the shareholders. This encouragement is generally enhanced where capital-gain income from the sale of the corporation stock is exempt from tax or subject to tax at a lower rate than dividend income. The United Kingdom of Great Britain and Northern Ireland, the United States of America and many other countries employ this system.

The effect of this system on the tax cost of reinvestment may be simply illustrated. Assume corporation X
earns $100, and pays a corporate tax thereon of $50, whether the earnings are retained or distributed. If the corporation distributes $50 of after-tax earnings as a dividend to an individual shareholder, say in a 50 per cent marginal income-tax rate, the after-tax benefit to him of the $100 of corporate earnings will be reduced to $25. Now assume the $50 is retained by the corporation and the value of the shareholder's stock increases by $50. Assume also that on liquidation or sale of the stock, the capital-gain rate is one half of normal rates, or 25 per cent. The investor's after-tax benefit in that case, from the same $100 of earnings, will be $37.50, or 50 per cent greater.

This kind of system is sometimes criticized as involving “double” taxation. Whether this criticism is true, however, depends upon whether the corporate-income tax is passed on to consumers or back to suppliers, or, alternatively, is not shifted, but, in fact, borne by the enterprise. The answer to this basic question, always a subject of lively debate, usually cannot be conclusively established and it may well vary, depending upon the particular country and the circumstances of the individual enterprise. Regardless of the true incidence of the corporate tax, however, it is clear that a two-tier system encourages retention of earnings in the corporation.\(^2\)

It is also important to note that the two-tier system does not ensure that the retained earnings shall be used productively. Because of the bias for retention, corporate earnings may be retained in idle reserves solely to deter or avoid tax. Thus, to rationalize the pro-retention bias of the system, the tax laws often provide for penalty taxes on personal holding companies (so-called “incorporated pocket-books”) and on unreasonable accumulations of earnings beyond legitimate needs of the corporate businesses.

Developing countries having such a two-tier system might well want to design strict penalty taxes to encourage optimally productive reinvestment. Alternatively, it is possible to design the over-all corporate tax system with incentive features to direct retained earnings into relatively productive channels. This matter is discussed further below under corporate-level incentives.

Between the two-tier system and the partnership type of system are a variety of systems with differing degrees of integration. A number of countries with a two-tier tax system use a so-called “split-rate” device to moderate its pro-retention bias. They impose lower rates on the corporation with respect to distributed earnings than those which apply to retained earnings. For example, retained earnings could be taxed at 50 per cent and distributed earnings at a rate of 20 per cent, so that distribution of one half of corporate earnings could lower the corporate effective rate to 35 per cent. In comparison with the basic two-tier system, the cost of retention at the corporate level is increased.\(^3\) As a rule, however, some earnings are distributed and some retained within such a system. The split-rate device reduces the bias of the two-tier system towards retention, but it does not eliminate that bias, as would a fully integrated system.

Another approach is to afford the individual shareholder a credit (avoir fiscal) against his personal-income tax on dividend income for all or a portion of the tax paid at the corporate level. France has such a system and Canada is currently considering such a system in its White Paper proposals. These systems can be fully or partially integrated, depending upon how large a credit is allowed.

A fully integrated system can be illustrated as follows. Assume a corporation with profits of $100 pays a corporate tax at the rate of 50 per cent, or $50. If the remains $50 is distributed to the individual shareholder, the $50 tax paid by the corporation is treated as a credit to the shareholder. Thus, the shareholder is treated as having income of $100 (the dividend is grossed up by the amount of the credit). If his rate of tax is 60 per cent, he would have a tax of $60 less a credit of $50, or a net tax of $10.

Even a partially integrated system (where, for example, only 50 per cent of the corporate tax is allowed as a credit to the shareholder), like a split-rate system, provides some encouragement for distribution, as compared with a non-integrated system. It differs from the split-rate system in that the stimulus comes not from a variation in the tax rate at the corporate level, but through a tax benefit for dividend income for the shareholder.

Still another approach is to give the corporation a deduction from income for amounts paid to shareholders. This system, like a split-rate system, raises the cost of retention at the corporate level with respect to the cost of distribution.

Where the shareholder is itself a corporation, most tax systems provide for elimination or reduction of the dividend tax. There are many variations in this approach; but the underlying theory is that a dividend from one corporation to another does not, as a rule, remove funds from investment to consumption and should therefore be treated differently from a dividend to an individual.

\(^2\) It should be re-emphasized that taxation is only one of a variety of factors affecting the decision whether to distribute or reinvest profits. Institutional and economic considerations may, in any given case, outweigh the effects of the tax system. In this connection, see R. J. Briton and C. R. Tomkins, “The Impact of the introduction of corporation tax upon the dividend policies of United Kingdom companies”, The Economic Journal, Vol. 80 (September 1970), p. 617. The author states that publicly held enterprises in the United Kingdom tended to maintain the level of their dividend payments notwithstanding the introduction of corporate tax designed to increase retentions. As a rule, the analysis in the present paper assumes that investment in developing countries is undertaken by large multinational corporations through wholly owned subsidiaries. The institutional and economic factors that might, for example, require a publicly held corporation to maintain a certain level of dividend payments do not have direct application to its subsidiaries; and concrete tax and financial considerations are likely to play a correspondingly greater role. The multinational corporate structure permits a maximum capacity to be responsive to relative tax advantages.

\(^3\) A split-rate device can also be used to encourage retention of a rate on distributed earnings greater than that on retained earnings. Such a split rate could be used to fortify the retention bias of a two-tier system or to counter the distribution bias of a more integrated system.
Retention as policy objective

Developed countries usually moderate the pro-retention bias of two-tier systems for a variety of policy considerations. One is the view that distributed profits will tend to flow into the most productive investments available to the shareholder. Thus, the market-place will guide the use of the funds. Another reason is to prevent deferral or avoidance of personal-income taxes. By imposing a higher cost on retention, it becomes likely that earnings will be kept in corporate form only to the extent needed for productive purposes. It may also be thought desirable fiscal policy to make funds available for consumption purposes as a stimulant to the economy.

These considerations usually have less force in the case of a developing country. Typically, developing countries rely heavily on imports of consumer goods; and the release of funds from investment to consumption may do little to stimulate the domestic economy, while, at the same time, it may worsen balance-of-payments strains. Further, funds accumulated in a corporation are unlikely to remain idle where money is scarce and interest rates are high. These economic and monetary considerations may well outweigh the revenue losses from emphasizing retention of earnings at the corporate level.

To the extent the developing country relies on foreign capital in its economic development, the arguments for a pro-retention bias grow stronger, since withdrawal of earnings abroad is clearly not beneficial to the domestic economy and results in immediate adverse balance-of-payments consequences.

Thus, as a general conclusion, it would seem desirable for a developing country to adopt a tax structure with a pro-retention bias, such as a two-tier system, with the same corporate tax rate on distributed and undistributed earnings and a relatively high rate of taxation on dividend withdrawals.\(^4\)

In practice, the tax treatment of dividends usually depends upon whether the recipient is an individual or a corporation and, further, upon whether the recipient is a resident or a non-resident. Many countries impose either no tax or a very low tax on intercorporate dividends, so as to allow a corporation using subsidiaries as business vehicles similar flexibility to that enjoyed where branches are used. In contrast, an individual shareholder is, as a rule, taxed at higher, progressive rates. Where the recipient is a non-resident (individual or corporation) outside the jurisdiction of the host country, the dividend tax, if any, is in the form of a flat-rate withholding tax. In tax treaties between developed countries, it is frequently provided that intercorporate dividends shall enjoy a reduced rate of withholding tax, a provision which is mutually beneficial where investment flows in both directions. In the case of a developing country, however, there is no mutual benefit from reductions.

The tax laws of many developing countries do not provide for any withholding taxes on dividends. Where dividend withholding taxes are imposed (e.g., Ghana, India, Indonesia, Israel and Liberia), the rates are often not so high as to represent a serious deterrent to distribution, especially, of course, where the recipient is entitled to a tax credit under his own tax system. Indeed, where special tax-holiday schemes are applicable, developing countries generally offer full tax exemption on dividends remitted from earnings of the holiday period.

Such exemptions and relatively low rates for withholding tax on dividends paid to non-residents are used to promote withdrawal of profits rather than reinvestment. The usual explanation is that investors find the lower rates or the complete exemption attractive; and, hence, they may lead to greater new investment. This rationale is especially difficult to accept where it is not clear the investor will, in fact, derive benefit from either the low rates or the exemption.

Even more difficult to understand is the fact that most countries that offer tax holidays compound the stimulus to disinvest by imposing a time-limit on distribution of tax-exempt dividends from earnings of the tax-holiday period. This practice was criticized in the report of the United Nations Expert Team on Harmonization of Fiscal Incentives to Industries in the Caribbean Free Trade Area (E/CN.12/845). A provision that accords exemption to dividends from the holiday profits, whenever distributed, at least removes the adverse timing stimulus. Or, indeed, it may be preferable to allow tax-exempt dividends from tax-holiday profits only after a period of years has elapsed.\(^5\) More basically, however, it may be desirable to re-examine the underlying policy with respect to exemptions or low rates on dividend withholding taxes. This question is to be considered further in the light of the following examination of the various systems used by capital-exporting countries to tax foreign income.

TREATMENT OF FOREIGN-SOURCE INCOME BY CAPITAL-EXPORTING COUNTRIES

Deferral and remittance

Where investment is undertaken abroad through locally incorporated subsidiaries, the capital-exporting country typically defers taxation of earnings until they are distributed as dividends to the shareholder. As a result of such deferral, corporate-level tax benefits accorded to the subsidiary by the host country may be used to advantage. Thus, tax holidays, reinvestment allowances and the like at the corporate level enable the investor to accumulate tax-free earnings in the host country for reinvestment. The amount of the tax benefit from deferral depends upon the effective rate of corporate-level tax imposed by the host country. The lower the corporate-level tax, the more earnings can be retained for reinvestment.\(^6\)


\(^5\) For example, Sierra Leone provides that tax-holiday profits can be distributed tax-free only after five years from the end of the tax holiday.

\(^6\) For an analysis of the role of deferral, see United State Income Taxation on Private Investment in Developing Countries (United Nations publication, Sales No. E.70.XVI.2), pp. 27-30.
To illustrate the benefits of deferral, assume that an investor can obtain a pre-tax rate of return on a domestic investment of 20 per cent, or 10 per cent after payment of a 50 per cent tax. Assume further that he reinvests all of his after-tax earnings during the first five years. During that period, his earnings on a $100 domestic investment would be as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment</th>
<th>After-tax return</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>100.00</td>
<td>10.00</td>
</tr>
<tr>
<td>Second</td>
<td>110.00</td>
<td>11.00</td>
</tr>
<tr>
<td>Third</td>
<td>121.00</td>
<td>12.00</td>
</tr>
<tr>
<td>Fourth</td>
<td>133.10</td>
<td>13.31</td>
</tr>
<tr>
<td>Fifth</td>
<td>146.41</td>
<td>14.64</td>
</tr>
<tr>
<td>At the end of five years</td>
<td>161.05</td>
<td>61.05</td>
</tr>
</tbody>
</table>

Now assume that the investor invests $100 in a developing country with a five-year tax holiday and earns the same pre-tax rate of return.

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment</th>
<th>After-tax return</th>
</tr>
</thead>
<tbody>
<tr>
<td>First</td>
<td>100.00</td>
<td>20.00</td>
</tr>
<tr>
<td>Second</td>
<td>120.00</td>
<td>24.00</td>
</tr>
<tr>
<td>Third</td>
<td>144.00</td>
<td>28.80</td>
</tr>
<tr>
<td>Fourth</td>
<td>172.80</td>
<td>34.56</td>
</tr>
<tr>
<td>Fifth</td>
<td>207.36</td>
<td>41.47</td>
</tr>
<tr>
<td>At the end of five years</td>
<td>248.83</td>
<td>148.83</td>
</tr>
</tbody>
</table>

As a result of the tax holiday, the investor’s original investment of $US 100 has grown to $248.83, as compared with $161.05 for his domestic investment.

The increased after-tax earnings may be used to distribute larger dividends to shareholders. Or the increased earnings may be realized through a liquidation or by a sale of the stock. Depending upon the tax treatment of gain on such liquidations or sales of stock of foreign corporations, the investor may be able to reduce substantially his over-all tax burden by taking advantage of deferral and not distributing earnings currently. Thus, in the foregoing example, assume that a sale of the stock or liquidation of a corporation produces a capital gain taxable at 25 per cent. In that case, a sale of the domestic investment would produce a net after-tax gain of $45.79, and a sale of the foreign investment would produce $111.62. Thus, the foreign investment produces about 2.5 times as much net after-tax profit. This strategy of realizing the benefits of deferral through ultimate disposition is, in fact, commonly employed by multinational business organizations and other investors that can afford to defer current income.

Where operations in a developing country are conducted through a branch of a corporation organized in the capital-exporting country, the benefits of deferral are often unavailable. While some countries exempt foreign-branch earnings from tax, or tax them at a lower rate, branch earnings are most often taxable where earned, whether or not they are, in fact, remitted to the home country. Thus, branch operations are generally used only in special circumstances, such as those of mineral industries where large deductions (“losses”) are anticipated and it is advantageous to have these available to offset the tax of the home country on other income.

**Systems of taxation in capital-exporting countries**

In its study of fiscal incentives for private investment in developing countries, which is largely based on an analysis of a two-country model, the Organisation for Economic Co-operation and Development (OECD) distinguishes four different groups of capital-exporting countries in accordance with the way they tax current income from abroad. The categories identified are:

1. **Group A: exemption method.** Countries granting complete tax exemption to domestic corporations on dividends received from foreign subsidiaries. In some cases, these countries also exempt foreign-branch profits (Canada, Netherlands, Switzerland);

2. **Group B: tax-deduction method.** Countries taxing dividends from foreign subsidiaries at normal rates but allowing, in effect, for deductions of foreign tax by taxing only the net dividend received from abroad. As a rule, these countries apply the same principles to foreign branch profits (Austria, Ireland, Luxembourg, Norway);

3. **Group C: special-rate method.** Countries taxing dividends from foreign subsidiaries and profits from foreign branches at a lesser rate than that applied to domestic business profits (Belgium, France, Italy, Portugal);

4. **Group D: tax-credit method.** Countries taxing dividends from foreign subsidiaries and foreign branch profits at the same rate as applied to domestic business profits, but reducing the tax thus computed by the foreign taxes paid. This group is subdivided into those allowing a credit only for taxes applied directly on the dividend income of the parent firm (Federal Republic of Germany, Spain, Sweden, Turkey); and those also allowing “indirect” credit for taxes on the income of the subsidiary out of which such dividends are paid (Denmark, Greece, Japan, United Kingdom, United States of America).

Assuming a two-country model and current distribution of earnings, the effect on the investor of tax incentives offered by the host country depends largely upon which of these systems his home country utilizes. If the home country falls in group A (exemption), the investor will derive the full advantage of any tax reduction offered by the host country whether he operates through a subsidiary or a branch.

Investors from countries in group B (tax deduction) or group C (special rate) will derive only a limited benefit from tax reductions offered by the host country. The investor in a country in group B realizes only a fractional benefit as the reduction in the tax of the host country increases his tax base for taxes in the home country. If the group C special rate is high enough, it may cancel out most of the benefit of the host country reduction. If a subsidiary is used, however, the deferral feature will enable the investor to derive the benefit of corporate

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tax-rate reductions in the host country in accumulating profits for reinvestment.

The taxes of countries in group D (from which the largest share of foreign-investment capital is derived) would normally wipe out entirely the tax benefit afforded by a reduction in the host country of withholding taxes on dividends. The principal beneficiary of the rate reduction is the treasury of the country in group D, which, as a result, takes a larger portion of the ultimate taxes than it would otherwise receive.

Where investment activity is conducted through a subsidiary, however, full advantage may be taken of tax benefits offered by the host country at the corporate level because of the deferral feature. Thus, tax holidays, investment allowances, accelerated depreciation, reinvestment reserves and other devices, examined below in section C, may be fully effective in making funds available for reinvestment, whatever the nature of the tax system in the home country.

Where investment activities are conducted through a branch, tax reduction benefits will be realized by investors from different countries in approximately the same way that they realize the benefits of tax reductions or exemptions on distributions, i.e., fully in most countries in group A, not at all in countries in group D, and to varying degrees in countries in groups B and C.

Because rate reduction and tax exemption offered by the host country for branches or on dividends merely increase the amount of tax collectible by countries in group D, without substantially benefiting the investors, it is frequently claimed that tax-credit mechanisms “frustrate” the efforts made by developing countries to attract investment through tax concessions. For this reason, many developing countries have sought to negotiate so-called “tax-sparing” treaties with developed countries in group D, under which the latter would accord their taxpayers a credit for “phantom” taxes that the developing country has decided to forgo.

Before considering the arguments relating to tax sparing, it is necessary to consider some complicating factors. The foregoing analysis, based on a two-country model and an assumption of current distribution, is highly simplistic. In practice, third-country corporations (base enterprises) are often used to make investments in developing countries. Accumulation of earnings with a view to realizing gains only on disposition of stock is a common practice. These and other complications are often attributable to the investment strategies followed by multinational corporations.

**Multinational corporations**

Most private international investment is, in fact, undertaken by large corporations with assets, business activities and shareholders in many countries. These so-called “multinational corporations” are a reality of the international economy which must be recognized in any attempt at a comprehensive analysis of tax incentives.

Governments have increasingly become concerned about the political significance and the effects upon international relations of the growth and dominance of multinational corporations. Some have proposed new multilateral treaty arrangements to provide a fair, but controlled, legal régime for international corporate enterprise. They see a new international political and economic structure evolving from the world-wide activities of international business.

Whatever the future may portend, multinational corporations currently, to a large extent, establish their own, largely uncontrolled, international régimes for purposes of taxation. Thus, such enterprises usually have a network of enterprises which are based, at least in part, on accommodating to the taxing jurisdictions of many countries. These organizations, as a rule, make full use of third-country corporations (base enterprises) in connexion with investments.

For example, a United States corporation might have a French affiliate undertake an investment in a country of Africa that has particularly close connexions, including a tax treaty, with France. Or a United Kingdom corporation might use a Panamanian affiliate to invest in a country in Latin America. Given the world-wide nature of some of these operations, many choices usually are available in structuring investments in developing countries.

From the standpoint of developing countries, the phenomenon of multinational corporations with base enterprises operations means that the investor has considerable ability to maximize his net profit after any tax benefits accorded by the host country. He can often defeat the imposition of any residual tax in capital-exporting countries. For example, the basic strategy of a multinational corporation may be to expand its assets at the corporate level through reinvesting earnings and simply to let its shareholders have a build-up in the value of their stockholdings in the enterprise. Particularly because public shareholders are frequently involved and capital gains are exempt or taxed at preferred rates, investors may greatly prefer enhanced stock values to current distribution of earnings.

For example, a multinational corporation with its parent firm and a majority of its shareholders in the United States of America need not necessarily be concerned with the effects of the United States tax-credit system as it relates to foreign-source dividends because it could withdraw profits from a developing country to a base enterprise and invest the profits elsewhere without having them subjected at any point to United States tax jurisdiction. Reinvested earnings, which enhance the value of a corporation stock, may be realized upon indirectly by selling the stock of the parent firm at favourable capital-gain rates.

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8 Assuming, as is usually the case, that the tax rates of the developing country are lower than those of the capital-exporting country.

9 Statement made at the Conference on Foreign Direct Investment, Georgetown University, Washington, D.C., 12 October 1970.
TAX SPARING

Much of the debate with respect to tax sparing has focused on the question whether it is appropriate policy for developed countries to allow some of their taxpayers a tax "break" to promote investment in developing countries; and on arguments whether, as a matter of international comity, capital-exporting countries should defer to the decision of the host country that certain income over which the latter has jurisdiction to tax should remain untaxed.

Proponents argue that tax sparing is necessary to give effect to the incentive measures used by developing countries to achieve economic development. Failure to provide tax sparing results in enrichment of the treasuries of capital-exporting countries at the cost of developing countries.

Opponents of tax sparing argue principally that it constitutes a departure from tax equity as among taxpayers within the capital-exporting country. This argument is based on a concept of tax equity that holds that foreign-source income should be subject to the same burden as domestic-source income. The question of tax sparing is, in the eyes of its opponents, often related to concern whether multinational corporations, with the ability to control many elements of their tax environment, actually bear an appropriate over-all tax burden.

The proponents' rejoinder to the tax equity is that developed countries frequently depart from tax equity to promote activities they deem desirable.

A significant number of capital-exporting countries have accepted the principle of tax sparing. The Federal Republic of Germany, Sweden and the United Kingdom have each concluded at least six tax-sparing treaties; and tax-sparing treaties have also been concluded by Denmark, France, Finland, Japan and Norway.

The staunchest opponent of tax sparing is the United States of America, which at first negotiated several tax-sparing treaties, but then rejected that approach in favour of a special investment-credit approach. Several treaties were negotiated with an investment credit that paralleled the investment credit for domestic investment. However, the repeal of the domestic-investment credit in 1969 effectively destroyed that approach to encouraging investments in developing countries.

The Foreign Relations Committee of the United States Senate, on 19 November 1970, rejected even a limited investment-incentive provision negotiated by the Treasury Department in a tax treaty with Trinidad and Tobago, indicating that it was uncertain as to the wisdom of encouraging investments in developing countries.

It is evident that the question of the desirability of tax-sparing agreements, as such, raises basic issues of national policy. Capital-exporting countries place different values on encouraging private investment in developing countries and, indeed, change their policies from time to time. Developed countries also differ in the importance they place on notions of tax equity and fairness. Thus, some tend to be less doctrinaire about avoiding preferences and treating all taxpayers the same. Some capital-exporting countries might find other provisions, tax and non-tax, preferable to tax sparing. A special tax credit for investments in developing countries could, for example, be more consistent with the tax system of the home country. Alternatively, a country might prefer direct subsidies or special loans or guarantees to investors. In short, a judgement on tax sparing requires a balancing of various principles on which countries may differ.

From the point of view of this study, the more basic question is whether the dividend tax exemption (or reduced rate) that gives rise to the tax-sparing problem is itself sound policy for the developing country. Clearly, a tax exemption (or reduced rate) for dividends is inconsistent with the objective of encouraging reinvestment from retained earnings. If it can be justified, it is only on the grounds that it serves a useful function in attracting new investment.

The attractiveness of a dividend exemption is not susceptible of precise evaluation. Clearly, however, it is a costly benefit for the developing country to offer. If it were eliminated, the developing country could compensate for its absence by offering, for example, greater benefits at the corporate level, which would also increase the investor's net return on capital. These benefits might include increased investment allowances, tax holidays, accelerated depreciation and the like. Alternatively, the host country might offer non-tax benefits, such as subsidies or guarantees, which might even be more effective in promoting both reinvestment and new investment. The advantage of such non-tax benefits or of tax benefits at the corporate level is that they do not, of themselves, encourage distribution. Indeed, the combination of low corporate tax rates and high dividend withholding rates on foreign shareholders should provide positive stimulus to reinvestment. Furthermore, any revenue forgone at the corporate level directly benefits even an investor in a group D country that is not covered by a tax-sparing treaty.

An objection to eliminating tax exemptions on distributions is that not all investors come from countries in group D, and many countries in that group have already concluded tax-sparing treaties with developing countries. Investors from countries not in group D or from countries that have concluded tax-sparing treaties may prefer the incentive of low withholding rates to reductions in effective corporate rates. Moreover, as previously pointed out, many multinational business organizations, though originating in countries in group A, have organized their investment activities, for example, through the use of base enterprises in countries in group A so as to derive maximum benefit from dividend tax exemptions offered by the host country.

These are serious considerations, especially as they may reflect investor psychology. As a matter of finance,
however, the over-all rate of return of an investment in a two-tier system can be increased through reductions in either dividend withholding taxes or corporate-level taxes. Similarly, an increase in the one can be offset by a decrease in the other. A 20 per cent increase in dividend taxes results in no detriment to the investor if lower corporate taxes have made available 20 per cent more earnings for distribution.

The advantage to the developing country of eliminating a pro-distribution bias could be maintained by imposing or keeping dividend withholding taxes at a level that will not encourage distribution and compensating by offering investors off setting corporate-level tax benefits or non-tax benefits. While this system might risk short-run investor disapproval, the long-run advantages could be substantial.

It may well be that the situation in some developing countries is such that the corporate-level tax rates are already so low, or tax holidays so long, that trade-offs between dividend tax rates and corporate tax rates are not practical possibilities. For such countries, there may be advantage in the approach whereby the dividend tax exemption is granted to investors only to the extent that they, and not the treasury of their home country, will be benefited.12 This approach assures that the forbearance of the host country will not be wasted and eliminates the “reverse foreign aid” inherent in the interaction between the dividend exemption and the tax-credit mechanism, which is its most offensive aspect.

The issues are somewhat different when the question of tax sparing arises in relation to branch operations. It can be argued that even a capital-exporting country that does not adopt tax sparing for dividends from foreign subsidiaries should, as long as it accords deferral to foreign subsidiaries, adopt tax sparing for earnings of foreign branches of domestic corporations that are retained by the branch. One result would doubtless be to increase the attractiveness of branch operations. For various reasons, most investment-incentive statutes currently apply only to locally incorporated enterprises; thus, use of a branch would involve a sacrifice of these benefits. Of course, more developing countries could make tax incentives available to branches, but whether this is a desirable policy for developing countries goes beyond tax issues as it relates to the basic economic and legal relationship of the investor to the host country.

From a tax standpoint, branch operations involve numerous complications. There is the question of allocating income and deductions to the branch. Where the foreign corporation has activities in other countries, including home-office activity, such allocations can raise difficult problems for the investor, the host country and other countries where there are operations. Next, there is the question of imposing a tax on withdrawal of profits from a branch operation. Some countries impose some branch withdrawal tax to achieve equality with the treatment of dividends paid by locally incorporated subsidiaries. In the absence of such a branch tax, branches would be too highly favoured in relations to subsidiaries, and the revenue cost to developing countries would be considerable. There are also issues with respect to transfers of branch asserts to a corporation and whether such transfer can be done on a tax-free basis. Thus, from a tax standpoint, encouragement of branch operations carries with it the need to resolve a host of tax problems which go beyond the issue of tax sparing.

Furthermore, branch operations in developing countries are likely to be undertaken in circumstances where the capital-exporting country already provides tax benefits to such form of organization. Thus, branches may be used in the early years of an investment where losses are anticipated that can be used to offset home country income. Clearly, tax sparing would serve no useful function in these cases, as there would be no income tax during the loss years for the developing country to forgo.

A second example would be extractive industries, where operation through a branch enables the investor to make use of the special tax reliefs in his home country, such as current deduction of intangible drilling expenses or depletion deductions. One of the chief arguments for tax sparing is that it brings foreign-owned business into a situation of tax equality with locally owned business. As concerns extractive industries, however, this argument cuts the other way. The addition of tax sparing to the tax advantages already provided by the capital-exporting country would put foreign-owned businesses into a far more favoured tax position than that of locally owned businesses.

The advantages of branch operations in the instances described above are direct consequences of the absence of deferral.

C. Reinvestment incentives at the corporate level

Because of the deferral feature in the taxation of income from foreign subsidiaries provided by the laws of most capital-exporting countries, any tax forgone by the host country at the corporate level makes more funds available for distribution or reinvestment. Corporate-level tax benefits offered by developing countries can encourage reinvestment rather than distribution. Some measures, like tax holidays, are available regardless of the use to which the exempted funds are put. Other measures, such as the reinvestment allowance, are specifically geared to the encouragement of reinvestment and are available only for such purposes. Still another broad range of benefits, including investment allowances and depreciation, are accorded investment or reinvestment, but need not necessarily be used for further reinvestment. There are also provisions for tax-free roll-overs and loss carry-forwards that can lead to reinvestment, and relief from direct taxes and import duties.

Before examining and comparing these various devices as they relate to reinvestment, it should be pointed out that the effect of special incentives at the corporate level depends upon the bias of the basic system for taxation of corporations and shareholders as it encourages retention or distribution.

12 See article 8 of the draft Central American agreement on fiscal incentives to industrial development. Generally similar provisions are found in the laws of Barbados, Jamaica, Puerto Rico and Trinidad and Tobago.
The interrelationship between the basic tax structure and special reinvestment incentives in Israel has recently been studied. Under the general tax laws of Israel, which are based on the pre-1965 British model, there is a separate “company tax” on all profits, whether retained or distributed, and an “income tax” on corporate profits after deduction by company tax (including surcharge) and dividends paid. Thus, the effective rate on retained earnings is significantly higher than on distributed earnings. To correct this pro-distribution bias, Israel has instituted a special rate of income tax on earnings retained for reinvestment, which reduces, but does not eliminate, the difference. The results is unclear. As the study points out, “It is a bewildering task to draw a balance sheet of these conflicting tax rules and concessions to determine whether the tax system as a whole is biased toward retention or biased toward distribution”.

The general relationship between the basic tax system and the special investment incentives may be summarized as follows: (a) when the basic corporate-shareholder tax system favours retention, special incentives reinforce reinvestment; (b) when the basic system favours distribution, special incentives counteract reinvestment; (c) when the basic system has a neutral effect, special incentives provide only incentive for reinvestment. Thus, the most consistent policy would be one where a balanced package of corporate-level incentive measures is backed up by a basic corporate-shareholder system favouring retention.

**TAX HOLIDAY**

A tax holiday is a whole or partial tax forgiveness over a period of time. As a rule, tax holidays are provided under selective tax-incentive laws, and their use is very widespread among developing countries. The extent of benefits may be fixed or may vary with the quality and quantity of the economic contribution made by the “approved” enterprise. In general, the trend among developing countries is towards increasingly flexible or “tailored” tax-holiday incentive schemes. Another tendency is towards increasing regional uniformity as illustrated by common incentive arrangements in effect or under development in Central America, the Andean countries of South America, the Caribbean Free Trade Area and the East African Community.

Eligibility for a tax holiday is usually restricted to enterprises that are locally incorporated (whether owned by nationals or foreigners) and that are engaged in a “new and necessary” or “pioneer” industry.

Tax holidays are usually thought of as an incentive for new investment. Under a number of tax-holiday schemes, however, the extent of reinvestment is an important determinant of the scope of the benefits. In some cases, a commitment to reinvest a portion of earnings is a threshold condition for obtaining a tax holiday. For example, Pakistan requires that an exempted enterprise subject to a tax holiday set aside 60 per cent of its exempted profits for reinvestment purposes. Under the law of the Ivory Coast, 10 per cent of exempt profits must be invested in government development bonds.

Under other systems, the investor is given the choice of expanding his tax-holiday benefits through reinvestment. Under the Malaysian statute, all approved investments are eligible for a basic two-year tax holiday; but extension of the holiday period depends, in part, upon the level of investment or reinvestment. By investing or reinvesting a total of $1 million Malaysian dollars within a specified period, an enterprise may extend its tax holiday to five years (other criteria make possible a total extension of up to eight years).

Tying the tax holiday to reinvestment seems to be a useful way of assuring that some part of the benefits granted by the developing country will be reflected in increased productivity and in a better balance of payments situation. The approach of the Malaysian statute would seem to have psychological advantages over that used in Pakistan, as the absolute requirement of reinvestment might itself act as a deterrent to some new investment. The approach in Malaysia has the dual merit of tailoring the benefit to the extent of the contribution of the approved enterprise and of enabling both the Government and the enterprise to “wait and see” before determining the extent of their respective commitments.

In the absence of such special provisions as are found in the systems in Pakistan and Malaysia, the benefits of tax holidays are unrelated to actual reinvestment practices. Tax holidays give rise to additional after-tax income, which can, in general, be used either for reinvestment or distribution. In fact, the dividend tax exemption, which is almost universally associated with tax holidays, tends to tip the balance in favour of distribution, especially where there is a time-limit on taking advantage of the exempt-dividend privilege.

If dividend exemptions are available, it would seem to be wise policy to counterbalance the distribution bias with a provision such as that of Pakistan or Malaysia. On the other hand, the elimination of the dividend tax exemption might create a sufficient pro-reinvestment bias to make special reinvestment provisions unnecessary.

Special problems are encountered when a business that has enjoyed a tax holiday applies for an additional tax holiday in connexion with a contemplated reinvestment. The decision whether or not to reinvest comes after the...
privileged enterprise has produced earnings. Thus, the investor has had experience in conducting business in the developing country, and the presence of earnings suggests the experience has, in general, been favourable. Thus, at least some of the rationale that usually justifies the grant of tax incentives is not present at the time reinvestment decisions are made.

An important factor is whether the earnings are to be reinvested in the same business or in a new business. If a new business is involved that would qualify for special tax incentives in its own right (for example, because it is a "pioneer" or "new and necessary industry"), then tax incentives arguably should be available. Even if the funds are coming from earnings generated by a business that has itself enjoyed tax exemption, the character of the new business would seem to be the crucial factor. Similarly, if the new business itself would not qualify for special tax incentives, reinvested earnings as the source of the funds arguably should not make a difference.

There would appear to be no difference between earnings from an exempt business or a taxable business. Once the earnings are available, their treatment should depend upon the purpose of their reinvestment.

More difficult problems are presented when the earnings of a business that has itself qualified for tax exemption are to be reinvested in the same business. If the industry has not completely developed or further encouragement of expansion appears desirable, a case can be made for extending the concessions to the reinvested earnings.

In actual practice, it may be difficult to classify the activities to be undertaken with reinvested earnings as a new business or merely the continuation of an existing business. In this event, a careful reappraisal of the actual needs of the country ought to be part of the evaluation of whether to grant tax incentives to the expansion of the enterprise through reinvestment.

In considering reinvestment incentives, several points are clear. Both the investor and the Government have actual experience to draw upon. The uncertainties of an initial investment decision are not present. A more considered and less speculative decision can be made on both sides. This may suggest that flexibility to decide taking into account all the facts and circumstances is the most appropriate course.

Reinvestment Allowances and Credits

A number of countries, including Ecuador, Tunisia and Uruguay, adopt a direct approach to the encouragement of reinvestment. They grant tax deductions for income that is reinvested for approved purposes. Naturally, this incentive can only function after the tax holiday, if any, has expired. Thus, this incentive is usually offered in general revenue laws rather than in the selective tax laws applicable to new industries.

The tax deduction for reinvestment is a costly incentive from the point of view of the developing country since it forgoes revenue from enterprises that are already established and operating profitably. In theory, the incentive should apply only to productive reinvestment; and, therefore, the host country may be willing to pay a high price. But to ensure that reinvestment is, in fact, bona fide and within the Government-approved guidelines would seem to require even more careful administrative controls than those needed for screening new enterprises. In the absence of such controls, the opportunities for tax avoidance are obvious.

A number of problems are inherent in this kind of provision. One relates to the timing of the deduction, as compared with the actual reinvestment; that is, the question when the funds must be actually reinvested in order to be exempt from taxes when earned. Under the Uruguayan law, for example, up to three years are allowed. The opportunities for abuse are limited somewhat by the requirement that, in the interim, the funds must be placed in the Banco de la República and used to buy public obligations. But such control is not always provided for and, even where provided, may be ineffective. It has been suggested that "in countries with high interest rates, businesses may take advantage of reinvestment allowances in order to defer payment of income taxes, even at high penalty rates for failure to invest the funds in new plant and equipment." On the whole, a high price in forgone revenue is paid here to encourage reinvestment. An incentive to retention can be provided without direct revenue loss through higher dividend taxes. To the extent that positive incentives are necessary, an investment credit or allowance may provide lesser likelihood of abuse.

Investment Credits and Allowances

An investment credit functions by giving the business enterprise a credit against tax for some portion of the amount expanded in new plant or equipment. This device has been used on many occasions in developed countries, but it does not appear to have been widely adopted by developing countries. The more commonly used device is the investment allowance, under which a deduction against taxable income is allowed in excess of normal depreciation. This device can be provided without direct revenue loss through higher interest rates, businesses may take advantage of reinvestment credit in order to defer payment of income taxes, even at high penalty rates for failure to invest the funds in new plant and equipment. An investment allowance reduces the cost of acquisition of new productive facilities. The amount saved is usually available for either reinvestment or distribution. Thus, the benefit is a reward for current investment and not necessarily an inducement to future investment.

17 In Brazil, under the investment for incentives in the northeastern region, enterprises may deposit in a designated development bank one half of their tax liability along with additional funds, for reinvestment in approved projects. Depending upon the amount of additional funds required, which may be 25 per cent, 50 per cent or 75 per cent, depending upon the project, the over-all revenue cost may be greater or less in relation to the reinvested amount than under a simple reinvestment deduction system.

18 George E. Lent, Tax Incentives for Investment in Developing Countries, International Monetary Fund Staff Papers, Vol. XIV (1967), pp. 249 and 279.

19 The investment allowance is mainly found in developing countries that have been influenced by the British tax system, such as India and several countries of Africa.
ment. Unlike depreciation, an investment allowance does not merely defer tax liability; it eliminates it pro tanto.

An investment allowance may be provided in lieu of or in addition to a tax holiday. From the reinvestment perspective, an investment allowance has several advantages over a tax holiday:

(a) The investment allowance is available for investment or reinvestment at any time, while the tax holiday, in and of itself, does not provide any incentive to reinvestment and is generally available only for new investment;

(b) Tax holidays, in practice, involve exemptions at both the corporate and the dividend levels (though they need not necessarily do so); thus, they tend to set up a pro-distribution bias which the investment allowance avoids by confining the tax reduction to the corporate-level tax.

(c) The amount of tax benefit in a tax holiday depends upon the actual profits of the business, and may exceed the marginal incentive necessary to achieve the desired investment; the investment allowance is a fixed percentage of investment in productive assets and is thus geared to and limited by the amount of actual investment in capital assets.\footnote{Some tax-holiday schemes limit the amount of income that may be exempted with reference to the investment level. Among the countries having such schemes are Guatemala, India, Iraq, Liberia, Philippines and Senegal.}

Some of the counter-arguments in favour of tax holidays are that investment allowances favour capital-intensive industries rather than labour-intensive industries which may be more appropriate in the circumstances of a given developing country. Tax holidays, in contrast, are neutral in this respect. Furthermore, the psychological appeal of a tax holiday is generally assumed to be greater than that of investment allowances.\footnote{For further comparison, see Jack Heller and Kenneth M. Kauffman, Tax Incentives for Industry in Less Developed Countries (Cambridge, Mass., Harvard Law School, 1963); Lent, op. cit.}

These observations suggest that investment allowances may be more appropriate than a tax holiday for developing countries at a relatively higher stage of industrial development, where more capital-intensive industry can be assimilated and where investor confidence is sufficiently high to overcome the probable psychological preference for the tax holiday.

In Morocco, the investment allowance has evolved into an outright grant or subsidy, whereby the Government contributes directly 20 per cent of the cost of approved capital items. This technique has the advantage of reducing capital costs, regardless of whether the enterprise has taxable income, which is helpful even at the early stages of an investment where neither an investment allowance nor a tax holiday would provide any benefit. On the other hand, the necessity for having earned taxable income in order to benefit from an investment allowance or tax holiday acts as an automatic principle of selection which is not present for a subsidy system. The absence of such a “screen” may increase the risk of uneconomic use of government funds. This objection, however, may be overcome to some extent through careful selection criteria for recipients and projects eligible for the subsidy. Probably the principal reason that tax allowances, rather than subsidies, are usually employed is that it may be psychologically easier for legislatures to forgo revenue than to appropriate funds for the benefit of private interests. To the extent that a tax expenditure budget is kept, this factor would lose significance.\footnote{See discussion in section D.}

**ACCELERATED DEPRECIATION**

Accelerated depreciation permits rapid write-off of the costs of acquisition of capital equipment. It differs from an investment allowance principally in that it merely defers, but does not eliminate taxation; the more depreciation taken in early years, the less there will be available in the latter part of the useful life of an asset.

Like investment allowances, accelerated depreciation may be provided in special tax-incentive legislation or in general revenue laws. In this connexion, one of the recurrent problems in connexion with tax holidays is the time relationship between the holiday and depreciation deductions. If depreciation must be taken during the tax-holiday period, the benefit will be lost, since it could not be offset against otherwise taxable income.

In most cases, tax-incentive systems allow for the deferral of depreciation deductions until the close of the tax-holiday period. Such provisions preserve the depreciation deduction, and, in effect, extend the tax holiday by making deductions allocable to the holiday period available to offset post-holiday income. Under the system in Israel, depreciation would be taken during the holiday period (the tax holiday there involves only a reduction of, rather than complete forgiveness of, taxes on income); but depreciation could also be used to defer the start of the tax holiday, since the latter begins only when the enterprises has taxable income. The apparent effect of this system is to encourage maximum investment in the early stages, while somewhat reducing the incentives for reinvestment during the holiday period.

In most insinances, however, the investor will tend to discount heavily the value of future benefits. As a result, such benefits may provide little actual incentive though the cost to the Government is, none the less, high. If the depreciation deferral is seen as merely a prolongation of a tax holiday which is already of adequate length, it is clearly subject to criticism. On the other hand, it can be argued that the deferral of depreciation deductions encourages additional capital investment during the holiday period that might not be undertaken in the absence of an incremental tax advantage.

Accelerated depreciation makes funds available for either distribution or reinvestment. If it is combined with a dividend tax exemption or low rates, the tax bias would favour distribution, while relatively high dividend withholding taxes would encourage retention.

If a dividend tax exemption is offered as part of a tax holiday, deferral of depreciation until after the tax holiday tends to make more profits available for tax-free
distribution during the holiday period. If there is also a time-limit on the payment of exempt dividends, great pressure for distribution arises.

The significance of accelerated depreciation (or other special allowances) is affected by provisions for a “recapture”. While recapture provisions that cause a restoration of taxable income detract from the incentive aspect of the allowance, they may, nevertheless, be a desirable feature of the measure. Provided that they are limited to such circumstances as premature disposition of property in which recapture is clearly justified, they ensure the integrity of the measure so that it will achieve its desired results and not be a vehicle for tax avoidance.

**Roll-overs and Carry-forwards**

Most modern tax systems generally impose taxes on the gains from the sale or exchange of property, including corporate stock. In many countries, however, the laws provide that taxpayers may sell or dispose of property without imposition of tax on resulting gains if they reinvest the proceeds. Such “roll-over” provisions are particularly common in the case of involuntary dispositions, for example, if property is destroyed by fire, storm or other disaster and insurance proceeds are received. Roll-over privileges are occasionally restricted to reinvestments in like-kind property or to specified types of property; often, however, the privilege is generally accorded to all reinvestment transactions.

Closely related to “roll-overs” are provisions allowing reorganizations, recapitalizations or other changes in corporate structure without imposition of tax.

Most tax systems permit carry-over of losses as a means of reducing the adverse effects of annual tax-accounting. Such provisions allow, in effect, a rough averaging over time of the taxable income of the business and encourage an investor to continue his business. Further loss carry-overs are important to the effective functioning of incentives, such as investment credits or allowances. Without the carry-over, the tax benefit of such incentives would be lost once deductions equalled income. Where a tax holiday is in effect, the absence of a carry-over would preclude any tax benefit from the investment credit or allowance.

Tax-incentive systems involving a tax holiday usually provide for the treatment of the entire tax-holiday period as a single accounting period for the purpose of determining net losses. As a rule, the net losses may be taken immediately following the tax holiday or carried over until they are utilized.23

Such treatment of losses is essential to most tax-incentive schemes. The investor usually must anticipate losses in the early years. Tax exemption in that period is meaningless. If losses had to be taken in the tax-holiday period, the exempt enterprise would be worse off than a non-exempt enterprise having the benefit of a loss carry-forward to use against taxable income. The deferral of any net losses until after the tax-holiday period ensures that such losses shall be available to offset taxable income when it arises.

**Relief from Indirect Taxes and Duties**

Other important areas of tax benefits at the corporate level are exemptions from indirect taxes, such as special excise on sales taxes, import duties and export taxes. Developing countries typically rely heavily on such revenue sources. Unlike income taxes, these charges are payable regardless of whether the enterprise realizes a profit. While such taxes are generally considered to be passed on to consumers or back to suppliers, they may constitute a significant cost of doing business.

**D. Non-tax incentives for reinvestment**

Although this study is concerned with tax measures, it would be incomplete without some consideration of other techniques which may be available to developing countries to encourage reinvestment. Policy-makers are increasingly cognizant that tax-incentive measures involve costs in the same manner as direct subsidies. In the United States of America, for example, considerable thought has been given to the possibility of keeping a tax expenditure budget which calculates the costs of particular tax preferences.24 Only by a careful weighing of the costs of a tax measure against the intended benefits can a reasonable judgement be made as to its efficacy.

As previously mentioned, the costs of a dividend exemption should be weighed against the alternatives of further corporate-level incentives and non-tax benefits. With the same cost to the Government, an investor may receive more encouragement to invest under a pattern of corporate-level incentives for investment, backed by non-tax benefits, than he does through a dividend exemption. Further, non-tax benefits may be provided by either developing countries or capital-exporting countries, or both, so that a number of alternatives are available.

Governments may reduce the costs of an investment by direct loans or by guaranteeing investor-made loans. Governments may assist in providing plant sites, low-priced electricity or other resources, or manpower training programmes to adopt labour supply to manpower needs of the investor. Governments may help in establishing markets for products and, in general, in facilitating the enterprise. All of these items also increase profitability, often as directly as tax measures.

In focusing on tax considerations, there is a tendency to overlook the problem that most foreign investors are less sure of the security of their investments in developing countries than of the investments they make at home. Investors often seek to minimize the amount at risk abroad by recovering their investment as rapidly as possible. Unless they can be reassured as to the security of their investments, the effect of tax considerations on reinvestment decisions is likely to be minimal.

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23 Some countries limit the number of years during which the losses may be used. The limit is seven years in Israel, six years in Jamaica and five years in Mexico. In other countries, e.g., Nigeria and Sierra Leone, the carry-over period is unlimited.

Many Governments of developing countries provide guarantees of convertibility and non-expropriation as part of their basic incentive schemes. Other guarantees are sometimes made with respect to future tax levels and the bases for computing tax. These guarantees are undoubtedly helpful in reassuring investors so that they may reinvest earnings to maximize their long-run return rather than anxiously repatriating their capital at the earliest opportunity. But investors may also be skeptical of guarantees by the developing country because of the possibility of changes in basic policy that could nullify the guarantees themselves. For this reason, it is likely that guarantees offered by capital-exporting countries in co-operation with developing countries are a source of greater assurance to investors.

Close inspection of a tax-incentive programme that appears to be operating relatively successfully usually discloses a general pattern of government programmes favourable to private investment. Tax-incentive measures may have their greatest effect as a signal to the investors that the over-all investment climate, especially as it can be affected by the Government, is favourable.

E. Concluding observations

Reinvestment by foreign investors offers economic and monetary benefits for developing countries. Successfully inducing reinvestment can be seen as maximizing the benefits to be derived from private investment.

Tax measures used to stimulate reinvestment can be either positive or negative in approach. Positive incentives, such as reinvestment allowances, investment credits, accelerated depreciation and the like, impose a direct cost on the developing country in lost revenues. On the other hand, a negative stimulus, such as a tax penalty for withdrawal of earnings, could result in a direct revenue gain.

A number of factors have to be considered, of which the first is the over-all structure of the tax system. If income taxes are not a major factor, it may be difficult to provide any incentives for reinvestment. Indirect taxes do not lend themselves to encouraging or restricting distribution of earnings.

Secondly, with respect to income taxes, questions arise whether there are separate taxes on corporate and individual income, an integrated system, or some variant of a split-rate system; and what the effect is on reinvestment or distribution of earnings in general.

As a general principle, retention and reinvestment are encouraged through a "two-tier" structure with relatively high rates of withholding tax on dividend distributions. In practice, such high withholding rates are seldom employed; and, indeed, many developing countries offer temporary exemptions from withholding taxes as part of their tax-incentive package. The reason for this practice is concern that high withholding taxes may act as a deterrent to new investment.

The crucial question involves weighing the relative positive and negative effects of a higher tax on dividend distributions.

For some investors, the existing low rates or exemptions on withdrawals are less significant because the revenue forgone is absorbed by tax-credit mechanisms in their home country, or largely diluted by the special rate or deduction system in that country. While tax-sparing treaties would assure that the revenue loss would not become reverse "foreign aid", they tend to enshrine a dubious system which itself bears serious re-examination.

Tax benefits offered at the corporate level make money available for either reinvestment or withdrawal. Most such benefits are themselves neutral as between those alternatives. The use to which such funds are put depends in large measure upon the general tax structure and its bias with respect to reinvestment.

A tax holiday is a relatively blunt instrument of tax policy. Its benefits often are illusory because it is operative only during early years when losses are more likely to occur. If the tax holiday is limited to taxes at the corporate level, it can be consistent with a policy of encouraging reinvestment after the early years of the enterprise.

The investment credit or allowance has significant advantages with respect to the tax holiday in that it is usually available at any time and not merely in the early years. An additional advantage of the reinvestment allowance is that it at least purports to discriminate between productive reinvestment and other forms of retention and limits its benefits to the former. This kind of fine discrimination may be difficult to make in practice, however, and the cost is high for the developing country that allows a current deduction for earnings earmarked for reinvestment at a future date.

The benefits of an investment credit or investment allowance are usually not realized until funds are actually used to purchase capital items, though, as a variation, a tax deduction can be allowed for amounts reserved for reinvestment deposited without interest in the Central Bank. Since the credit or allowance is only a percentage of the cost of acquisition, the revenue forgone will, as a rule, be far less than under the so-called "reinvestment allowance".

Better results are achieved in terms of reinvestment by spreading out its benefits over a period of years rather than by concentrating them in a few early years. This can be achieved by emphasizing investment credits and allowances over tax holidays.

Accelerated depreciation has, in general, the same advantages and disadvantages as the investment allowance or credit. The fact that depreciation is limited by the cost of the item acquired, while investment credits and allowances are in excess of normal depreciation, means that the tax benefit of accelerated depreciation is only as a deferral and tends to produce less of a saving.
ANNEXES

ANNEX I

Taxation of royalty payments by licensees in developing countries *

A. NATURE OF TECHNOLOGICAL KNOW-HOW

In a modern manufacturing enterprise, where a considerable amount of attention is given to innovation, there is a constant search for better manufacturing methods and for product improvement. Many manufacturing organizations maintain research laboratories; but most of the technology that is productive of licensing income results not from laboratory inventions, but from attention given to the manufacturing process at the factories.

The value product of these innovative efforts is knowledge, which is recorded in various forms—in reports, instructions, drawings, sketches, formulae, routines, etc.; and, in some cases, in the less permanent form the expertise of employees of the manufacturer. Such information, usually called "know-how", if sufficiently valuable and rare, is entitled to the protection of law against theft, unauthorized transfer or unauthorized use, and has a sufficient number of attributes of property to be considered proprietary in nature, being, in fact, referred to as "industrial property", or "proprietary information".

The legal systems of most countries of the world recognize two general methods of protecting the owner's rights in proprietary information. As a rule, the courts of the various countries afford protection to the owner of proprietary information and will respond to his complaint against a party who has obtained unauthorized access to industrial property. The second and more widely recognized method of protection is the patent system, whereby, in return for a disclosure of an innovation or invention to the public, the Government assures to the inventor that for a limited period no one may use his invention without his consent, which may be conditioned on a royalty payment.

While the types of inventions that can be patented in the various countries of the world are somewhat restricted by the definition of patentable inventions in the various industrial property laws, it is usually recognized that industrial property or proprietary information is a form of intangible property wholly aside from the question of whether it has been patented or not. The transfer by disclosure of unpatented proprietary information can be conditioned upon the payment of a royalty in just the same fashion as is done in a patent licence.

The process by which income is earned through the production and use of industrial property is not essentially different from the similar process involving the production and use or sale of tangible capital goods. Certain costs are incurred in the development of the proprietary information. If the development is successful, a valuable asset is created. Its value may be realized either through sale which produces a fund of money either greater or less than the costs of development and, therefore, a profit or loss; or the industrial property can be "rented" (licensed) to one or more users for a consideration usually called a "royalty". If the market for such licences is sufficiently strong, the owner of the industrial property may recover his total costs and realize a profit.

B. ACCOUNTING FOR LICENSING PROFITS

Two methods of accounting are in general use to determine the profit or loss from the licensing of patents and know-how. Under the first method, the costs of developing proprietary information are identified and charged to a capital account. The gross receipts from the sale or licensing of the proprietary information are reduced by a suitable amortization of the capital account thus set up, and the resulting net profit or loss is recorded in the income statement of the business. The balance-sheet of the business would show the capitalized value of such industrial property on the asset side.

Assume that industrial property is developed during year "zero" at a cost of 20 currency units, and is licensed for a period of 10 years (years 1-10) for 3 currency units per annum. A. Under accounting method No. 1, the 20-unit cost in year "zero" does not reduce net income for that year, but appears as an amortized cost over the following 10-year period at the rate of 2 units per annum. The net income from the 3-unit per annum licensing receipts is therefore 1 unit per annum.

TABLE 1. ACCOUNTING METHOD No. 1

<table>
<thead>
<tr>
<th>Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross licensing receipts</td>
<td>-3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Less related costs</td>
<td>-2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Net income before tax</td>
<td>-1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

The second and more conservative method of accounting for the licensing of industrial property records the cost of developing such property as a charge against the income of the business. There are two main reasons for this procedure. First, the major portion of the costs of developing licensable industrial property are incurred in the factories rather than in research laboratories; therefore, it is

* The figures used to show the accounting methods by which net royalty income can be recorded are hypothetical and can be adjusted in accordance with the particular case. The difficulty of arriving at an approximation of the true costs of earning royalty income should be clearly understood. The cost of earning net royalty income is made up primarily of three elements: discovery costs, which are included research and development expenses; protection costs, which include the costs of obtaining patents and of enforcing them; and costs of transferring the technology and servicing the licensee. For the purposes of certain government contracts, contractors are required to estimate the second and third categories. These costs are principally those involved in identifying and transmitting the technology to licensees. These estimates vary with different types of technology and go as high as 50 per cent, excluding discovery costs, which are very difficult to identify and to allocate properly. It must be recognized that a manufacturing enterprise does not develop technology solely for the purpose of licensing, but principally for the purpose of use in the manufacture and sale of goods. Thus, expenses of developing technology are one of the costs of earning manufacturing and sales income, as well as of earning royalty income; and they tend to be regarded as expenses of the former activity. Determining the amount of these costs that should be allocated against gross royalties to produce net royalty income presents a problem that cannot be answered in generalities, but must be solved on a case-by-case basis.

* In the preparation of this paper, the United Nations Secretariat had the assistance of Walter Beaman, United States Branch of the International Fiscal Association.
virtually impossible to separate these costs from other current expenses of manufacturing, although, with effort, it may be possible to do so. Secondly, it is prudent to recognize the uncertainty of realizing significant amounts of income from the licensing of know-how and patents. Conservative accounting favours a method reflecting a pessimistic view of licensing prospects, except in those rare cases where the innovation is one where there will be an obvious and immediate demand for the development. When this second method is used, identifiable development costs are charged to expense and unidentified development costs are lumped with other categories of expense or inventory, with the result that there is no setting-up of a capital fund on the books of the business. Its income statement shows a current diminution of net income by reason of these costs, and royalty income from successful licensing is therefore not balanced by an amortization charge. As a result, annual licensing income appears to be larger than in the case of method No. 1 described above. The balance-sheet of the business does not record development costs as an asset.

Under method No. 2, the 20-unit cost becomes a charge against income for year "zero", setting up a 20-unit diminution of net income for that year. During the 10-year licensing period, the 3 units per annum in royalty receipts are not diminished by any amortized charge, with the result that the annual net income from licensing appears to be 3 currency units; in other words, the gross income appears to be the net income.

<table>
<thead>
<tr>
<th>Table 2. Accounting method No. 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
</tr>
<tr>
<td>------------------</td>
</tr>
<tr>
<td>Gross licensing receipts</td>
</tr>
<tr>
<td>Less related costs</td>
</tr>
<tr>
<td>Net income before tax</td>
</tr>
</tbody>
</table>

The tax laws of most of the industrialized countries allow taxpayers to compute their taxable net income with the use of either of the two methods of accounting described above. It can be expected that those businesses which desire to postpone taxation of net income will elect the second method for tax purposes, while those businesses which prefer to incur net income taxes currently rather than in the future will elect the former method. In some cases, it is possible to use method No. 1 for the computation of book net income and method No. 2 for the computation of taxable net income.

C. ACCOUNTING AND TAX CONSEQUENCES

The foregoing information on accounting practices has been set forth because in developed countries the management of a business is powerfully influenced by the effect of such actions on reported net income and on net income taxes. While there are still some businesses that are run by unsophisticated managements, the trend is towards greater and more precise analysis of every income-producing element of a business, with a view to determining whether any given activity should be continued, ceased, modified or shifted into another mode. The tax effect on net income from licensing is a controlling determinant of profitability, and can be assumed to dictate whether the management will press licensing, de-emphasize it or forbid it in favour of alternative methods of developing income from proprietary information.

If licensing of proprietary information should produce the pattern of income assumed in the foregoing example (see Tables 1 and 2), the income-tax consequences of domestic licensing would be as follows, assuming a net income tax rate of about 50 per cent.

Under method No. 1, the tax effect would be nil for the year "zero", and 0.5 units for each year of the 10-year payment period, for a total of 5 currency units of tax, leaving a net income after tax of 5 units.

Under method No. 2, the deductible expenditure in year "zero" sets up a tax benefit of 10 units, either by way of tax reduction for year "zero" or by way of a tax loss carry-forward. The annual tax for the subsequent 10 years amounts to a total of 15 units, before any possible carry-forward. This tentative amount must be treated as diminished by the tax benefit of 10 units, making the net tax 5 units and the net income after tax 5 units. Thus, both methods ultimately result in the same net tax, but method No. 2 provides a greater deferment of tax than method No. 1.

D. INTERNATIONAL LICENSING: TAX CONSIDERATIONS

The facts set out above have been based on the assumption that the development of the proprietary information and its licensing take place within the owner's home country and that the taxable income is therefore obviously generated entirely within that country. Consideration is given below to the geographical source of income for the purposes of net income taxation when the licensee is a foreign firm employing the technology in a country different from that of the licensor.

The international tax treaty programme has proceeded on the basis that a State has the primary right to levy a tax upon business income generated within its borders. In determining where business income is generated, the usual assumption is that the net income from business is produced at the location where capital and labour are employed. If income is produced by the employment of tangible property and the services of people wholly within a single country, only that country will be entitled to tax the net income so produced. The simplest example of the application of this principle is that of the production of inventory items wholly within a single country, with part of the goods so produced finding their way into another country by purchase and sale.

Assume, for example, that silk scarves are produced in country X and are seen there by the owner of a retail clothing-store located in country Y. If the buyer purchases a quantity of the scarves in country X, directing that they be placed aboard a car for shipment to country Y, the source of the income is, under this assumption, wholly within country X, because the seller in country X has employed no property and no services in country Y.

The international tax convention programme recognizes this case by providing that a seller in one Contracting State shall not be taxed in the other Contracting State (where the buyer is located) unless the seller comes into the buyer's State and employs property and services there to a significant degree; i.e., by maintaining in the buyer's State a "permanent establishment." If the seller should employ property and services in the country of the buyer to an extent satisfying the permanent-establishment concept—for example, if a seller of scarves should set up a local sales office in country Y to take and accept orders for scarves manufactured in country X, the country of the buyer could tax; but the tax would fall on only so much of the net income as is earned by the activities of the local office in country Y. The entire net income from the sale is assumed to be earned by the entire process of production and sale, which takes place in part in the country of the seller (where the manufacture occurs) and in part in the destination country (where the manufacturer's employees are engaged only in the sale and distribution of the manufactured product).

If the sales office in the destination country is separately incorporated from the manufacturing facility in the seller's home country, a natural division of net income occurs, either by an intercompany sale between the related enterprises for resale at a margin in the destination country, or by a commission billed to the manufacturing enterprise by the selling enterprise, in case the title passes directly from the manufacturing enterprise to the ultimate buyer. If the manufacturing facilities and selling facilities are within the same corporation, the branch office in the destination country is treated
as if it were separately incorporated and dealing at arm's length for
the purpose of determining what portion of the entire net income
from the production and sale is earned within the destination
country.

Under these rules, if a productive machine were manufactured by
a seller in country X and sold to a buyer for use in country Y, where
the seller has no permanent establishment, the entire income from
the production and sale of the item would be regarded as arising in
country X, that being the only country in which the seller employed
capital and labour in earning the net income. In country Y, the
buyer would capitalize the cost of the item and depreciate that cost
over its useful life. In this manner, the entire amount paid by the
buyer to the seller would be subtracted from the gross receipts
earned from the use of the item in the destination country in deter-
mining the net income generated by the buyer's use of machinery in
that country. The latter's net income would be subject to taxation by
the destination country. The seller's net income would be subject
to taxation only in his home country. No part of the seller's net
income would be attributable to the buyer's use in country Y of
the machinery purchased from the seller.

The process by which proprietary information ("know-how") is
generated and transferred can be looked upon as directly analogous
to the production and sale of capital goods. The proprietary infor-
mation is developed by the employment of property and services
(capital and labour) in country X. It may be kept secret by the owner
and used in the production of goods for sale; or it may be "sold"
(disclosed for a fee), either in the seller's home country or in a
foreign country. If it is sold in an international sale, the net income
from that sale may be regarded by the country of the seller as having
arisen from the employment of capital and labour in the home
country, with the result that the home country will consider itself
justified in levying an income tax on the entire net income. In the
buyer's country, the cost of the proprietary information will become
a deduction from the income generated by the buyer's use of the
know-how there, usually by way of amortization of capital expen-
situres; and the net income generated by the buyer will be the
measure of the income tax of the destination country.

If the analogy outlined above should be adopted as a maxim of
taxation, the State of the seller would tax the income derived by the
seller from the sale of tangible capital goods and the sale of the
intangible proprietary information without distinguishing between
them. The State of the buyer would also make no distinction. In
neither case would the seller be taxed by the State of the buyer
because it would be recognized that the seller had earned no income
by operations conducted by him in the buyer's State. The value of
the cash remitted from the buyer's State to the seller is exactly
balanced by the value of the tangible or intangible property that the
seller has transferred to the buyer's State. Therefore, the remission
of payment by the buyer to the seller would not be subject to any
income tax, by withholding or otherwise. The buyer would pay
income tax on the net income generated by the tangible or intangible
property, and such tax would be all that the destination country
would be entitled to receive.

The same result would occur whether the payment for the capital
item (tangible or intangible) was made at the time of sale or was
deferred and remitted over the period of the buyer's use of the item,
as is often the case with know-how purchases or licenses.

In fact, however, there is no international agreement that the
sale of capital goods and know-how should be treated similarly; and
they are not so treated, with the result that the solution to the
problem of international double taxation worked out for the sale
of goods is not applied to sales or licenses of know-how.

With respect to international sales of goods, the problem has
largely been solved by nearly universal acceptance of the propo-
sition that income arises where capital and labour are employed for
its production, and the auxiliary proposition that where such
employment occurs in more than one country, the entire net income
is produced in proportion to the relative quantities of capital and
labour employed in various segments of the production and distri-
bution process in the respective countries. Recognition of this
principle has precluded demands by destination States for net
income taxes on sales of goods exported from other countries
without the intervention of a permanent establishment in the desti-
nation country; and if such a permanent establishment is employed,
recognition of the principle has confined the tax demand to an
appropriate part of the net income of the transaction, which would
have been earned by arm's length dealing.

The same cannot be said of the international sale of technology.
The funds derived by the seller from a transfer of proprietary
information have been regarded by the country of the seller as
income taxable in the seller's country, whether the amount derived
is received in a lump sum or is received over a period of use, as in a
licence situation. At the same time, the State of the buyer has not
regarded the amount paid to the seller as having the same non-
taxable character as a payment for the importation of tangible
capital goods; and such payments have uniformly been subjected to
a tax in the buyer's State, usually by withholding. If unrelied,
this situation of double taxation can be quite severe, as can be
seen by use of the figures given in tables 1 and 2.

Assume that proprietary information is sold or licensed for a
payment of 30 currency units spread over a 10-year period at the
rate of 3 units per annum as in method No. 1. Further assume that
there is a withholding tax in the buyer's country with a rate of
33 1/3 per cent of the amount remitted. The total amount received
by the seller will therefore be 20 currency units. Referring to table 1,
it will be seen that the costs related to the generation of the prop-
erty information amount to 20 units. Therefore, the net income
before foreign tax is 10 units; and a tax of 10 units would amount to
an imposition of tax at a rate of 100 per cent of net income, obvi-
ously an unacceptable situation which will result in unwillingness
to make technology transfers.

If the seller employs method No. 2, which is the more con-
servative accounting practice of writing off the costs of develop-
ment as incurred, rather than over the life of the proprietary infor-
mation developed, the situation must be analysed with a slight dif-
ference. As the receipts are paid over the 10-year period, they are
paid by the seller's home State as if they were 100 per cent net
income, even though the total payment of 30 units must be dimin-
ished by the 20-unit total of related costs in order to determine
the true net income. The reason for this is that the 20-unit cost has
previously been used to diminish the tax on other net income, and
the inclusion of gross receipts from later realization of income from
the developed property must be done to balance the tax reduction
previously obtained by the early write-off of the 20 units. As each
annual instalment of 3 units is paid, it is first subjected to the
33 1/3 per cent withholding tax rate of the payor's country, and then
to the 50 per cent rate of the payee's country, for an effective rate of
66 2/3 per cent of 30 currency units. This double tax of 20 units is
offset by the previous tax benefit obtained in the home country in
the amount of approximately 10 units, with the result that, over
all, the tax is 10 units, or at the same effective rate of 100 per cent as
results from the use of method No. 1.

Under either method, the 100 per cent effective tax rate is unac-
ceptable and would prevent international transfers of technology.
Attempts to relieve double taxation in this case have taken two
forms: the granting of a foreign-tax credit by the country from
which the technology is exported; and a reduction in withholding
taxes by the country of destination.

If the double taxation is relieved by the granting of a foreign-tax
credit by the country of export, the following analysis would apply.
First, it can be assumed that the credit cannot exceed the amount
of the tax that the home country would ordinarily levy at its rate of
approximately 50 per cent on the receipts from the know-how
transfer. Assuming that these receipts are 3 currency units per
annum for 10 years, as in the previous examples, and the seller
keeps accounts according to method No. 1, the annual net income
tax in the seller's country would be 0.5 units (50 per cent times one unit). Since the withholding tax in the buyer's country would amount to 1 currency unit (33 1/3 per cent of 3 currency units), the foreign-tax credit would exceed the limit allowable in the seller's home country, with the result that the tax in the home country would be reduced to zero, and the effective tax would be the amount withheld by the buyer's country. Under method No. 1, a withholding tax of 1 currency unit per annum would be exactly sufficient to wipe out the before-tax net income of one unit; or, put another way, the withholding tax of 33 1/3 per cent of gross income would amount to a tax on net income at a rate of 100 per cent.

If the seller keeps books according to method No. 2, the home country tax paid in any year would amount to 1.5 currency units; and if the rules of the home country permitted the elimination of that entire tax by a foreign-tax credit, the withholding tax of 1 currency unit would be absorbed against the 1.5-unit home tax so that no double taxation would occur. Taxpayers who use method No. 2 are, however, still not certain of the full allowance of the credit because of the following argument currently being made by the tax authorities of their home country. While the tax being paid each year during the 10-year productive period equals 1.5 units per annum, the true tax paid must be reckoned by subtracting from the 1.5 units per annum (15 units for the 10-year period) the amount of tax reduction enjoyed at the time when the related costs of producing the technology were deducted in arriving at taxable net income. These costs (assumed to be 20 units) result in a reduction of taxes in an amount approximating 10 units; therefore, the total amount of tax that can be offset by the foreign-tax credit is not 15 units, but only 5 units. If this rule is imposed, the result is that the total withholding tax of 10 units (33 1/3 per cent of 30 units) wipes out the tax of the home country only to the extent of 5 units, but is not further creditable. The total home tax of 10 units will be offset by the earlier tax benefit of 10 units, leaving the withholding tax as the remaining tax on the international transaction. Since that tax amounts to 10 currency units and the total net income from the sale is 10 currency units, the effective rate of the tax in the destination country is 100 per cent. It will be seen that the argument would result in equalizing the status of taxpayers who use method No. 2 and those who use method No. 1. Both would forfeit 100 per cent of their net licensing-income to withholding taxes.

Consequently, sellers of technology located in developed countries do not wish to license their technology in countries having high withholding taxes on royalty income, because the foreign-tax credit granted by their Governments will not be adequate to relieve international double taxation and to reduce the total tax burden to an acceptable level; i.e., to the level of the net income tax in their own country. Economic pressures will therefore dictate that such sellers should avoid technology transfers and exploit the technology at home by the production of goods for export sale to the countries where the goods are needed, since the export sale of the goods made with the technology will result in more favourable tax treatment than the transfer of the technology itself.

If this analysis is correct, the conclusion to be drawn is that the minimum counteraction necessary to remove this barrier to international transfers of taxation from developed countries is a reduction in the withholding tax in the destination country to a point where the effective rate of taxation by both countries will not exceed the effective tax rate in the home country.

Using the examples previously discussed to compute the point at which this would occur, one arrives at the following calculation: a withholding tax of 33 1/3 per cent is equal to a net income tax of 100 per cent; therefore, a reduction in the withholding tax to approximately 16.5 per cent would result in an effective net income-tax rate of approximately 50 per cent. It is for this reason that many of the international treaties for the relief of double taxation specify that the rate of withholding on royalty income shall not exceed 15 per cent. It should be mentioned in this connexion that tax conventions between developed countries often reduce the rate of withholding to zero.

If the withholding tax of the country of destination is reduced to zero, the seller will pay tax at approximately 50 per cent (the assumed rate in his home country on the net income from the exportation of the technology, and the country of destination will collect net income tax only on the net income from the use of that technology by the transferee (a domestic taxpayer) in the destination country. Under the view that net income should be taxed where property and labour are employed to produce it, this result would be a proper one.

A theoretical alternative to the reduction of withholding by the transferee country is a petition by developing countries to developed countries designed to solve the double-taxation problem by a concession of the developed country. This would take the form of a relaxation of the limit on the foreign-tax credit that could be taken for withholding taxes collected by developing countries on payments for technology. To take a specific example, assume that a technology licensor keeping books under method No. 1 was permitted to credit the full withholding tax of 1 currency unit against his domestic tax liability, notwithstanding the fact that the domestic tax on the annual net income received is only 0.5 currency units. This would amount to a subsidy granted by the developed country to the developing country, in that the developed country would forgo collecting tax on other income earned in the developed country in order to remove the double-taxation barrier to the transfer of technology to a developing country.

The principal difficulty with this alternative proposal is that removal of the limit on the credit would open the developed country to the possibility that developing countries might raise the rates of their withholding taxes to unconscionable levels, simply because the additional tax so collected would be passed along by the licensor to the treasury of his country. This possibility would make a proposal for removing the limit on the foreign-tax credit acceptable only if it were coupled with a limit on the rate of the creditable withholding tax in the developing country, imposed by treaty or otherwise. For example, a developed country might be willing to modify its foreign-tax credit provisions to allow a separate credit for foreign withholding taxes on royalty income up to a rate of, say, 25 per cent. This would be a unilateral concession not requiring a treaty. In the alternative, an acceptable lifting of the limit might be accomplished by a treaty negotiation in which the developed country would agree to remove the limit if the developing country agreed that the rate of withholding should not exceed a stated percentage.

Many developed countries, however, do not give foreign-tax credits for foreign withholding taxes on royalty income, but merely treat the foreign tax withheld as not part of the taxpayer's gross income. To ask that an unlimited foreign-tax credit be instituted in such a country may be asking too much.

E. Summary

Licensable technology is proprietary information which arises from attention to manufacturing processes and attempts at the improvement of materials and products, as well as from laboratory research. Proprietary information is legally protected as property by most legal systems throughout the world, and, in some cases, it also enjoys the protection of the patent system.

The process of earning income through the development, use or licensing of proprietary information resembles the manufacture and use or sale of capital goods. In both cases, the costs of developing the property are liquidated by the proceeds generated by its use or sale, and an ultimate profit or loss results. This profit or loss may be computed by either of two permissible methods of accounting. If the costs of discovering proprietary information are capitalized and amortized over the useful life of the technology, the net income or loss is evenly spread. If these costs are written off when incurred, the result is an initial diminution of net income, followed by a corresponding increase in apparent net income in later years. The ultimate net income is necessarily the same regardless of which
accounting method is used, but the use of the second method tends to indicate that the net (taxable) income is larger than is actually the case.

If capital goods are produced in one country and transferred to another country for use there by another owner, the two countries normally divide the tax on the total profit (from the production and the use) as follows. The country of origin taxes the difference between the originator's costs and the sum paid from the second country. The second country taxes the difference between the sum paid and the amount realized in the second country by the employment of the property there by the enterprise of the second country. If, instead of tangible capital goods, the case involves the development and sale (licence) of technology for use in a second country, the two countries could provide for a similar division of the total revenue from the development in the first country and the use in the second country, by providing that each country would tax only that part of the total net income from the total transaction which is realized by its own taxpayer. This division of income from licensed technology has been achieved by treaties between developed countries; but, in the absence of treaties, the practice has been for both countries to levy a tax on the originator. The tax of the home country is levied on the difference between the originator's costs and the sum paid to him from the transferee country. The tax of the transferee country is levied on the total sum paid to the originator from the transferee country and is usually collected by withholding from that sum.

Some transferor countries do not grant foreign-tax credits or other unilateral relief for royalty income. In such cases, the consequences of double taxation can be severe.

If the transferor's country allows its taxpayers to subtract from or credit against their income tax in the home country the foreign tax so paid, partial relief of the double taxation can be obtained; but if the foreign tax is large, the amount thereof may easily exceed the limits of creditability set by the laws of those countries which unilaterally allow relief through foreign-tax credits. The credit cannot exceed the amount of tax levied on the licensing income by the transferor's country. That tax is a percentage of the net income from the licence, the excess of receipts over costs. The tax authorities of the home country may insist on an identification and recognition of these costs in an amount satisfactory to them. In this process, a withholding tax of 30-35 per cent of gross royalties levied by the transferee's country can be the equivalent of a tax exceeding 100 per cent on the net income as calculated by the taxing authorities of the transferor's country, with a consequent discouragement of transfers of technology and encouragement of its alternative use in the originator's country in the manufacture of goods for exportation.

The alternative remedies for the double-tax impediment to technology transfers are: (a) reduction of tax by transferor countries through the granting of foreign-tax credits or exemptions; (b) reduction in the withholding tax of the country of use; or (c) a combination of the two methods.
ANNEX II

Issues relating to taxation of royalties submitted by the member from India

During the discussions at the first meeting of the Ad hoc Group of Experts on Tax Treaties between Developed and Developing Countries, held at Geneva from 2 to 13 December 1968, the following issues relating to the tax treatment of royalties in a tax treaty between a developed country and a developing country were identified:

(a) The scope of "royalties" under article 12 of the Organisation for Economic Co-operation and Development (OECD) Model Convention; the question whether amounts received for the lease of modern machines, such as computers, film rentals and payments for use of patents for exploitation of natural resources should be included in the scope of "royalties";

(b) The question which country or countries should have the right to tax royalties. If rentals for modern machines, film rentals and payments for use of patents for exploitation of natural resources were excluded from "royalties", which country or countries would have the right to tax those items of income;

(c) The question whether taxation in the source country should be on a net or gross basis;

(d) The question of the proper method to be used and the extent to which the country of the residence of the lesser of the patent or other property producing the income should relieve double taxation.

A. Scope of "royalties"

Article 12 of the OECD Model Convention deals with the tax treatment of royalties. Paragraph 2 of that article defines "royalties" to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films; any patent, trade mark, design or model, plan, secret formula or process; or for the use of, or the right to use, industrial, commercial or scientific equipment; or for information concerning industrial, commercial or scientific experience. As mentioned in the commentary on article 12, this definition of "royalties" brings within the scope of that term the income received as consideration for the use of, or the right to use, three distinct forms of property, namely: different forms of literary and artistic property; industrial and commercial property, both tangible and intangible; and information concerning industrial, commercial or scientific experience. The commentary further makes it clear that the definition covers both payments made under a licence and the compensation that a person would be obliged to pay for fraudulently copying or infringing the right.

Although, under the definition, rentals of cinematograph films are within its scope, the commentary envisages a different treatment for such rentals in tax treaties by classifying these as industrial or commercial profits, which would, in consequence, be governed by the provisions in articles 5, 7 and 9 of the Model Convention.

The definition clearly excludes from the scope of royalty variable or fixed payments for the working of mineral deposits, sources or other natural resources. These are specifically covered by article 6 of the Model Convention relating to taxation of income from immovable property.

A proper definition of the scope of "royalties" in a tax treaty has to be evolved not on any considerations of pure principles or semantics, but rather in the context of its implications on the tax treatment of the different elements that may be included in that term. To some extent, the definition has to be in accord with the concepts already obtaining in the statutory tax laws of the treaty countries so as to avoid disputes as to the proper treatment to be accorded to different kinds of receipts in a given situation. The practical difficulties in devising a suitable definition acceptable to the treaty countries are clearly brought out by the circumstance that even among the member countries of OECD, reservations have been made not only concerning the basic approach of the Model Convention—that royalties should be taxable exclusively by the home country of the recipient of the income—but concerning the tax treatment of the different elements covered by this term. Thus, Canada, while agreeing to exempt from tax copyright royalties and other like payments for production or reproduction of any literary, dramatic, musical or artistic work, has reserved its right to exclude from this treatment rents or royalties in respect of cinematograph films, including films or video tapes for use in connexion with television.

Certain significant differences exist between copyright royalties and similar payments for the use of artistic, literary, musical and similar other works, on the one hand; and royalties for the use of patents, technical know-how and other industrial and commercial property or rights, because the creation or production of artistic, literary or other similar works does not involve research and development expenditure on a continuing basis, whereas patents, technical know-how etc. do involve such expenditure. The element of expenditure incurred by the author of a literary or artistic work in relation to the royalty income would, ordinarily, be small, and the duration of a copyright is also considerably longer than that of a patent right. Patents, technical know-how and other industrial or commercial property or rights, on the other hand, are developed after considerable expenditure of time and money in research and development; and their continued use and exploitation entails further expenditure not only in improving the existing processes and developing new processes, but in servicing and policing the use of the patent or other right and taking timely action against its infringement.

The distinction between copyright royalties and industrial and commercial royalties requires further refinement under each category. With respect to artistic, literary, musical and other works, special treatment is called for in the case of cinematograph films, including films or video tapes for use in television. While, on the one hand, these forms of property require substantial expenditure in their production, their exploitation on a global basis involves less trouble than the production or reproduction of other literary or artistic works. Another distinction is that while copyrights over literary or artistic works are often sold outright, on either a global or a regional basis, cinematograph films and video tapes are not. Such films and tapes are usually exploited through the making of prints for use in different countries, while the rights of reproduction are retained by the original producer. Films and tapes of educational or technological value are, perhaps exceptional in that.

* See Tax Treaties Between Developed and Developing Countries (United Nations publication, Sales No. E.69.XVI.2), part one, paras. 92-97.
the exhibition rights over them are often acquired by educational institutions in developing countries for a lump-sum consideration, rather than on the basis of a rental. Another consideration that distinguishes film rentals from other types of royalties is the absence of any further effort by way of continuing research and development and comparative freedom from expenditure on servicing and policing the use of the film. The distinction can be brought out clearly by comparing, on the one hand, patents and other technical know-how for the production of films in general, and, on the other, the exploitation of a given film already produced by the employment of such patent or know-how. Clearly, once the cost of production of the film or tape has been recouped, further receipts from the exploitation of the film or tape constitute, almost wholly, income; and scarcely any expenditure is debitable against it. The question of the way in which the cost of production should be apportioned over the receipts from various countries in which the film is exhibited is considered separately. It is clear, however, that film rentals should appropriately be excluded from the scope of "royalties" and be dealt with separately in a tax treaty.

As concerns rentals of tangible personal property, such as computers and other machinery and equipment, it has been argued that such rentals contain an element of royalties because of the high technological component of this equipment, which is reflected in the sales prices or rentals charged for it. At the same time, it has been recognized that, unlike the case of patents, know-how and other industrial or commercial intangibles, a lease of tangible property, such as business equipment, does not involve any significant expenditure in policing the use of the equipment or in taking action against infringement. Servicing of the equipment may often be a necessary adjunct to the lease, but this is by no means as onerous as the responsibility involved in servicing a patent or other know-how. It has therefore been contended that rentals from leasing of tangible personal property should appropriately be treated as industrial or commercial profits rather than as royalties and that, in any event, a higher tax in the source country would be justified on rentals of tangible property than on royalties on intangibles.

Tangible equipment for use in business and industry is usually leased in a country on the basis of a servicing arrangement, which would, in most cases, bring the lessor within the purview of taxation in the source country on the basis of maintenance of a permanent establishment. If, therefore, rentals from leasing of such equipment were to be treated as industrial or commercial profits, the scope of "permanent establishment" could clearly be made to cover a servicing organization maintained in the source country by the lessor of such equipment. The remaining area where business equipment is leased without an ancillary servicing arrangement is likely to be negligible. It is therefore considered that the rentals of such business equipment should be treated as industrial or commercial profits in a tax treaty between a developed country and a developing country, and specific provision should be made to treat the organization servicing that equipment in the developing country as a "permanent establishment" of the enterprise supplying the equipment.

B. Question Which Country or Countries Should Have the Right to Tax Royalties

At the first meeting of the Ad Hoc Group, there was general agreement that the approach of the OECD Model Convention of taxation of royalties exclusively in the home country of the grantor or licensor and exemption of such income in the source country—was inappropriate in a tax treaty between a developed and a developing country. The view was canvassed that, as in the case of interest, a compromise solution must be found which, in effect, amounted to a sharing of the revenue between the two countries. It was recognized, however, that special factors were involved in the case of royalties, such as the monopolistic character of patents and the difficulties in calculating the expense element in the royalty income. To these may be added other considerations, such as the ease with which the burden of tax in the source country could be shifted by the grantor or the licensor to the user of the patent. There is ample evidence that this shifting is already happening to a considerable extent, and agreements for the use of patents and other know-how provide not only for a royalty based on the value of the articles produced by the use of the patent or know-how, but for ad hoc payments towards reimbursement of the cost of research and development, as well as for expenses for servicing the patent. Agreements of this kind effectively secure that the royalty based on the price of the articles manufactured virtually represents net income to the grantor or licensor, and the rate of such royalty is fixed after taking into account the rate of tax in the source country.

In view of this position and taking into consideration the foreign exchange and balance-of-payments problems that developing countries already experience due to the unidirectional flow of royalty incomes to industrialized countries, there is scarcely any case for the developing country to forgo any part of its tax on royalties flowing to industrialized countries. Accordingly, in a tax treaty between a developed country and a developing country, it would be appropriate to provide for full taxation of the royalty income in the source country. In any event, such a provision would be imperative where the statutory tax law of the developing country provides for taxation of the royalty income on a "net" basis. In bilateral negotiations, however, it may be open to the treaty countries to agree to limit the tax in the source country to a rate that may be agreed upon in relation to royalties payable under licensing agreements which may be entered into after the date of the treaty or in respect of new patents for a limited period, if, in either case, there is a reasonable assurance that such limitation in the rate of tax would be reflected in a corresponding reduction in the rate of royalty.

As concerns copyright royalties, there is even less justification for the source country limiting its rate of tax. The same applies to film rentals, subject to the reservation that where the statutory tax law does not provide for taxation of such income on the "net" basis, a suitable ad hoc rate may be agreed upon between the treaty countries after taking a broad judgement of the expense element in such payments.

Article 12 of the OECD Model Convention provides, in paragraph 3, an exception to the general rule in paragraph 1 of that article, to the effect that where the royalty income is derived from right or property that is effectively connected with the "permanent establishment" of the receiving enterprise in the source country, such income will be treated in the same manner as industrial or commercial profits and be governed by the provisions in article 7 of the Model Convention. Such a reservation would be of some relevance only where the treaty provides for the exclusive taxation of royalty income in the home State of the recipient. It would have no significance in a treaty between a developed country and a developing country that provides for full taxation of the royalty income in the source country. In any event, the utility of such a reservation is, at best, doubtful, as it would usually be possible for the contracting parties to delink the rights or property giving rise to the royalty income from any effective connexion with the "permanent establishment". As the provisions in article 7 of the Model Convention, relating to taxation of business profits, have repudiated the "force of attraction" principle, even a reservation on the lines of that in paragraph 3 of article 12 in a treaty allocating the right to tax royalty income to the home State of the recipient is not likely to serve any useful purpose in actual practice.

C. Net or Gross Basis

The OECD Fiscal Committee concluded that a tax treaty between a developed country and a developing country should provide for taxation of royalties in the developing country on a net basis at a moderate rate; or, if on a gross basis, at a rate not less equivalent to the tax that would apply if the net basis were used. The
Ad hoc Group, while generally agreeing that taxation on the "net" basis would be more rational, recognized, at the same time, that there were greater difficulties in determining the average expense element in royalty payments than in the case of interest payments.

In determining the expense element in royalty payments relating to use of patents and other industrial know-how, the following factors, among others, must be considered:

(a) Development of patents and know-how involves a long process of research and development, and the expenditure involved will be both on capital account and on revenue account.

(b) The flow of income from utilization of the patent will be spread over a long period of years and will be derived in part from profits that the enterprise developing the patent makes by the manufacture and sale of products in its own organization and in part by way of royalties from other enterprises to whom the patent has been licensed for use. While the latter element will be easily ascertainable, the former element cannot be quantified except on a broad estimate. Further, an apportionment of the costs referred to in (a) against the receipts and profits mentioned in (b) will be virtually impossible until the patent has been fully exploited over a period of years.

(c) The statutory tax laws of the industrialized countries already provide for recoupment of the cost of research and development from the profits yielded by the use of the patent either within the enterprise itself or by leasing it to other enterprises in the same country or other countries.

(d) It is, in general, the experience of developing countries that they are able to obtain from industrialized countries patents and know-how that have already outlived their use in the parent country, having been replaced by more sophisticated and modern processes and methods. Taking into account this circumstance, it will be justifiable to regard royalty income from the use of patents and know-how in developing countries as virtually amounting to a bonus to the industrialized country since the patent is, in any event, obsolete in that country.

Apart from the above-mentioned considerations, the pattern of licensing agreements usually adopted between enterprises of the industrialized countries and those in the developing countries virtually eliminates the need for allocating any of the costs of research and development to the royalty for the use of the patent in the developing country. As mentioned in the report of the Ad hoc Group, licensing arrangements, in general, provide for lump-sum payments towards the cost of development of the patent or technology, as well as for current expenditure in servicing the patent. The royalty based on the value of products produced by the use of the patent, therefore, almost wholly represents net income to the receiving enterprise.

To conclude, there is hardly any need in a tax treaty between a developed country and a developing country to go into the question of the expense element in royalty payments for the use of industrial patents and know-how. To the extent that the treaty countries agree to the allocation of taxing jurisdiction in respect of royalties between the two countries, it should be open to the source country to tax the full amount of royalty as if it were net income. In the rare type of case where the agreement for the use of the patent does not make a separate provision for reimbursement of research and development expenditure or current expenses on servicing, the treaty may provide for a reasonable allocation of such expenditure to the royalty income. Such allocation, however, is by no means easy in view of the several considerations mentioned earlier in arriving at a proper apportionment.

D. AVOIDANCE OR RELIEF FROM DOUBLE TAXATION

In a convention between a developed country and a developing country, the provision relating to royalties may be on the following lines:

(a) Royalties may be subjected to tax only in the source country or, alternatively, in the source country as well as in the home country of the licensor or grantor without any stipulation in the treaty for a limitation in the rate of tax in the source country. In bilateral negotiations, however, it will be open to the treaty countries to agree to limit the tax in the source country to a rate that may be agreed upon in relation to royalties payable under licensing agreements which may be entered into after the date of the treaty or in respect of new patents for a limited period if, in either case, there is a reasonable assurance that such limitation in the rate of tax would be reflected in a corresponding reduction in the rate of royalty. Film rentals and rentals of business equipment, such as computers, should be taxable in the source country without any limitation in the rate of tax.

(b) The term "royalties" may be defined broadly on the lines of the definition in paragraph 2 of article 12 of the OECD Model Convention, subject, however, to the following reservations:

(i) Film rentals may be excluded from "royalties" and dealt with under a separate article;

(ii) Rentals of business equipment, such as computers, may be treated as "industrial or commercial profits", and the definition of "permanent establishment" may be modified to cover specifically a servicing organization maintained by the lessor in the country in which the equipment is licensed for use. The reservation in paragraph 3 of article 12 of the Model Convention (namely, that royalties will be treated as "industrial or commercial profits" if the right or property giving rise to the royalties is effectively connected with a "permanent establishment" which the licensor has in the source country) is devoid of any significance and should be done away with.

(c) Taking into account the tenor of agreements for licensing of patents and other industrial property by enterprises of industrialized countries to enterprises in developing countries, there is scarcely any need to go into the question of the expense element in royalty payments for use of industrial patents and know-how. To the extent that the treaty countries agree to the allocation of taxing jurisdiction in respect of such royalties, it should be open to the source country to tax the full amount of royalty as if it were net income.

(d) Where the right to tax royalties is allocated exclusively to the source country, the home country of the licensor or grantor should exempt the royalty from its tax (with or without progression). Where the right to tax royalties is given to the source country as well as to the home country of the licensor or the grantor, the home country should relieve double taxation of its residents on their royalty income from the developing country by granting a credit against its tax for the tax actually charged in the source country.
Scope of the Problem

A. Outline of your country's income-tax legislation

Indicate generally in what circumstances (i.e., in the presence of what juridical contacts and with respect to which types of income) your country's tax legislation authorizes taxation of:

1. Income from sources outside your country accruing to residents of your country;
2. Income from sources within your country accruing to persons not residents in your country.

B. International income-tax evasion or avoidance

The term "international income-tax evasion" is used in this questionnaire to refer to:

1. Evasion of a country's income taxes by taxable non-residents and enterprises controlled by non-residents;\(^b\)
2. Evasion of a country's income taxes by residents with respect to their foreign-source income.\(^b\)

Show the estimated amounts of revenues lost as a result of each of the above-mentioned forms of international income-tax evasion, if figures are available.

Are you in a position to estimate the volume of outflow of funds that results from the desire of the owners to evade income and other taxes?

C. Predominant patterns of international income-tax evasion or avoidance

Describe the patterns of international income-tax evasion or avoidance which are of major concern to your Government. In answering, specify which, if any, of the following appear to contribute significantly to evasion or avoidance of your country's taxes:

1. Undeclared foreign-source interest, dividend, rental or royalty income accruing to residents of your country. Indicate the extent to which this undeclared income arises from investments made abroad by such residents for the purpose of continuing to escape your country's taxes on property or income concealed from your taxing authorities;
2. Undeclared foreign-source business profits accruing to residents of your country;
3. Undeclared foreign-source wages, salaries and other earned income accruing to residents of your country;
4. Overstatements by non-resident taxpayers doing business within your country, or by taxpaying enterprises doing business within your country which are controlled by non-residents—as well as domestic enterprises operating abroad—of expenses for services rendered abroad to such taxpayers and expenses for services rendered within the country to such taxpayers by non-resident technicians and experts not affiliated with such taxpayers;

5. Unrealistic prices reported by non-resident taxpayers doing business within your country or by taxpaying enterprises doing business within your country which are controlled by non-residents—as well as domestic enterprises operating abroad—relating to transactions between such taxpayers and persons or enterprises outside the country which are affiliated with such taxpayers (e.g., contracts between parent corporations and their foreign subsidiaries involving purchase or sale of goods, royalty payments, interest payments and management fees where the contract prices do not reflect realistic market values). Indicate whether such tax evasion or avoidance is motivated in part by efforts of such taxpayers to transfer profits outside your country in violation of your country's laws governing remission abroad of profits;

6. Use of "holding companies" or other agents located in foreign countries to receive income directly or indirectly accruing to residents of your country from sources situated in foreign countries;

7. Use by non-residents, to escape your country's income taxes, of "bearer shares" (shares whose owner is not identified) issued by enterprises situated within your country;
8. Use by residents of your country, to escape your country's income taxes on foreign-source income, of "bearer shares" issued by enterprises situated abroad.

What evidence do you have that any of these practices take place? What steps, if any, have you taken to prevent the loss of revenue resulting from such practices (e.g., does your law allow expenses incurred abroad by the enterprise)?

To what extent are your efforts to prevent income-tax evasion or avoidance frustrated by difficulties arising out of the legislation or administrative procedures abroad?

II. International co-operation through exchange of information

A. Existence of agreements and arrangements for exchange of information

1. Does your country currently have agreements or arrangements with one or more other countries for the exchange of information aiding in enforcement of income taxes and/or other taxes?

2. If the answer to question (1) is affirmative, please indicate:

(a) The countries with which agreements and arrangements exist relating to exchanges of information aiding in enforcement of income taxes and the form taken by each such agreement and arrangement (e.g., an informal exchange of letters between tax administrators or a provision of a formal agreement, such as a convention or treaty);

(b) The countries with which agreements and arrangements exist relating to exchanges of information aiding in...
enforcement of taxes other than income taxes, and the form taken by each such agreement and arrangement;

(3) Please attach copies of the texts of all provisions of agreements and arrangements to which your country is a party relating to exchanges of information aiding in enforcement of income taxes, unless they are already submitted for inclusion in the United Nations series of International Tax Agreements.

B. Description of exchanges taking place under existing agreements and arrangements

If your answer to question IIA (1) indicates the existence of agreements or arrangements between your country and one or more other countries for the exchange of information aiding in enforcement of taxes on income, please respond to the questions contained in this subpart B:

(1) Routine exchanges of taxpayer information

(a) With how many countries is information relating to taxpayers exchanged on a routine basis (that is, presented periodically without specific request)? (Provide such figures as are available with respect to how many taxpayers' information was given and received by your country in the course of such exchanges.)

(b) Indicate the kinds of information given and received in the course of such routine exchanges (e.g., salaries, interest, dividends, royalties, rents and capital gains paid from sources in the country supplying the information to residents of the other country). Please be as specific as possible in indicating the kinds of information exchanged.

(2) Taxpayer information exchanged upon specific request

(a) With how many countries is provision made for supplying information concerning an identified taxpayer or taxpayers upon receipt of a specific request for such information from the other country? (Provide such figures as are available with respect to how many taxpayers' information was given and received by your country in the course of such exchanges.)

(b) Indicate the kind or kinds of information most frequently given and received in response to the specific requests considered under this question IIB (2) (i.e., if information relating to income is exchanged, please specify the kinds of income most frequently involved—salaries, interest, dividends etc.; if information relating to expenses or other deductions is exchanged, identify the kinds of expenses or other deductions most frequently involved—payments for technological know-how, managerial services etc.).

(3) Information exchanged pertaining to income-tax laws and their interpretation

(a) With how many countries does your country exchange information pertaining to the respective countries' income-tax laws and their interpretation (see (e) below for examples of such information)?

(b) With respect to how many countries are these exchanges carried on pursuant to formal agreements between the Governments involved?

(c) Indicate the nature of such formal agreements (e.g., conventions for the avoidance of double taxation of income).

(d) With respect to how many countries are these exchanges carried on the basis of informal arrangements rather than formal agreements?

(e) Indicate which, if any, of the following items are included in such exchanges: (i) texts of statutes; (ii) texts of published regulations; (iii) texts of judicial or administrative decisions and opinions interpreting income-tax laws; (iv) texts of unpublished regulations or manuals for tax officials; (v) texts of tax guides and other materials prepared for the public; (vi) interpretations of provisions of your country's income-tax laws formulated in response to requests submitted by officials of the foreign Government to which such information is made available; (vii) other (e.g., proposed legislation; please specify).

C. Future steps to promote information exchanges

(1) Indicate generally what steps, if any, your country would like to take within the next few years to reduce the seriousness of international income-tax evasion or avoidance through exchanges of information. Specify whether it is intended to carry out such exchanges under provisions of formal agreements or merely under informal arrangements with one or more foreign tax administrations.

(2) A possible issue relevant to information exchanges between countries is whether substantial reciprocity in the amount and kinds of information given and received is viewed as a necessary element of such exchanges. It is possible that under an agreement between two countries, one country may not be able to supply as much information concerning taxpayers as the other country. This might be the result of legal limitations (e.g., bank secrecy laws) on its ability to obtain information concerning taxpayers. It might also simply reflect the non-symmetrical character of transactions between the two countries. (For example, many residents of country A may own shares of stock of corporations of country B, but relatively few residents of country B own shares of stock of corporations of country A. Country B could therefore give country A more information concerning dividends paid to residents of country A than country A could supply comparable information to country B.) Has your country entered into or considered entering into reciprocal exchange agreements?

(3) In addition to the general description of future steps to promote information exchanges contained in the answer to question IIC (1), indicate your country's plans with regard to the exchange of information of the specific kinds identified below. For each specific kind of information listed, indicate:

(a) If your country desires to expand agreements and arrangements with other countries entitling your country to receive such information;

(b) If your country would be willing to make monetary compensation to other countries for costs incurred in supplying such information;

(c) What obstacles, if any, could prevent your country from supplying such information to other countries;

(d) Whether your country would prefer to exchange such information on a routine basis or only in response to specific requests.

The kinds of information to be considered are the following:

(a) Information relating to foreign-source income accruing to residents of a country as interest, dividends, rents and royalties;

(b) Information relating to foreign-source income accruing to residents of a country as business profits;

(c) Information relating to foreign-source income accruing to residents of a country as wages, salaries and other earned income;

(d) Information relating to transactions by residents of a country in property situated in a foreign country;
(e) Information relating to expenses claimed as deductions from income by non-resident taxpayers doing business within a country and taxable enterprises doing business within a country which are controlled by non-residents, relating to services rendered to them abroad and services rendered to them within the country by non-resident technicians and experts not affiliated with such taxpayers;

(f) Information relating to transactions between non-resident taxpayers doing business within a country, or taxpaying enterprises doing business within a country which are controlled by non-residents, and persons or enterprises outside the country which are affiliated with such taxpayers.

D. Operational procedures to make use of taxpayer information available through routine exchanges

If your country desires to expand its routine exchanges of taxpayers information, indicate what operational procedures (e.g., cross-checking of returns) are currently in existence in your country to make use of such information and what operational procedures, if any, would have to be introduced to make use of such information.

E. Penalties and other sanctions

Please indicate:

(1) The penalties and sanctions, if any, available under your law to enforce provisions for reporting of taxpayer information (e.g., sanctions supporting requirements for reporting payments of wage and salary income etc.);

(2) The penalties and sanctions, if any, available under your law especially to deal with international income-tax evasion (e.g., rules requiring that all non-residents produce certificates proving payment of income taxes before being allowed to leave the country).

To what extent have these penalties been applied? Please provide any statistics you may have on jail sentences in connexion with tax evasion.

III. International co-operation in collection of taxes

A. Indicate what measures, if any, are in effect in your country to aid in collection of income taxes due to one or more other countries. Are such measures based solely on provisions of your country's laws, or do they result from agreements between your Government and one or more foreign Governments? If such assistance results from one or more international agreements, please identify the nature of the agreement with each of the countries involved and attach copies of the texts of all provisions of agreements relating to such co-operation.

* As well as domestic enterprises operating abroad.
ANNEX IV

Tax fraud and international co-operation: France *

Ever since the introduction of taxes based on returns by the taxpayers, the French tax administration has sought to arrive at means of exercising effective control. It has done so, on the one hand, by requiring the completion of certain formalities by the taxpayers themselves (e.g., registration of conveyances) or by third parties (intermediaries, such as notaries, banks, employers or debtors); and, on the other hand, by exercising very broad supervisory and investigatory powers (e.g., the power to have a deceased person’s safe-deposit box opened in the presence of a tax official to inspect all papers held in custody by banks).

However, despite all these means at its disposal, the French tax administration cannot combat certain types of fraud, especially fraud which occurs outside its territorial jurisdiction; for France’s geographical situation, the permeability of its frontiers, and political and financial crises have helped or encouraged some French nationals to invest part of their capital abroad and to receive the income from it in other countries.

The purpose of this study is to indicate what powers the French tax administration has under domestic legislation and under tax agreements concluded by France. In addition, it will attempt to suggest what are the necessary conditions and bases for greater international co-operation in combating tax fraud.

A. INTERNATIONAL TAX FRAUD AND FRANCE

The ease and rapidity of communications, the progressive elimination of obstacles to the movement of persons and property, and the expansion of international economic relations have enabled an increasing number of individuals and companies to escape taxation by taking advantage of the existence of frontiers beyond which the tax authorities of their own country have no power to act. The differences in the tax burden from country to country, the diversity of tax systems and the facilities provided by private law have considerably increased the possibilities of fraud.

Where France is concerned, a distinction may be drawn between the kind of fraud which enables residents of France to evade the tax they would normally be liable to pay on their income from foreign sources and fraud committed by non-residents of France to escape the tax on their income from French sources. There follows below an account of the guiding principles of French domestic legislation, after which the principal types of international fraud will be discussed.

1. Provisions of French domestic legislation

As concerns taxation of income from foreign sources derived by residents, in principle, taxpayers domiciled in France, have, subject to the application of international tax agreements, an unlimited fiscal liability in respect of French taxes. Such persons are liable to income tax on their entire income, whether from French or foreign sources.

On the other hand, the company tax is levied only on profits realized from an activity carried on in France. The Act of 12 July 1965 introduced into French legislation the “world-wide profit” tax system for French companies, but this is purely optional and must be approved by the Ministry of Finance. To date, the Ministry has given its approval in only a small number of cases. Under the French tax system, what income from foreign sources is taxable in France is determined according to the rules laid down for French income in the same category. The full amount of deductible expenses is usually allowed, but the taxpayer must be able to furnish proof that they were incurred.

As concerns taxation of income from French sources derived by non-residents, taxpayers who are not domiciled in France are liable, in general, to tax in France only on that part of their income which is derived from French sources. However, persons with one or more French residences may be taxed according to a flat rate based on the rental value of the residences. The taxation of such persons also depends on the location of their true domicile, their nationality and the nature of the French income derived by them. In fact, all these provisions go to make up a complex and not very homogeneous system.

2. Principal types of international fraud

The methods employed to escape tax internationally are, of course, very varied. Generally speaking, the categories of income which taxpayers can most easily avoid reporting consist of income directly or indirectly collected abroad. However, tax can also be evaded by having items of income transferred to a numbered bank account or through a “man of straw” who is the apparent recipient of the income.

For the sake of clarity, the principal types of fraud are listed below by category of income.

(a) Income from real estate

The taxpayer fails to report in the country of his domicile sums which he has received in rent or which may be assimilated to rent in the country where the property is situated. Such income may also escape taxation in the latter country if the tax authorities are not actually aware of the identity and domicile of the recipient.

(b) Business income

In this field, apart from deliberately failing to report income, taxpayers frequently take advantage of loop-holes in national laws and bilateral tax agreements in order to reduce their tax burden. In the case of this category of income, where the rule of territoriality usually applies, enterprises can, for the purpose of partially evading taxation, set up a permanent establishment in the State in which taxes are smaller, so that some of their operations will be taxed at a lower rate. They can also make use of companies controlled by them in order to transfer profits under the guise of ordinary transactions (purchases, sales at other than the normal prices) or by paying royalties for which there is no economic justification.

It may be advantageous, purely for tax purposes, for a company of a particular country to conduct operations with partners in another State and to create a relay in the form of a company established in a third country where taxes are low. Unless certain precautions are taken, it will even be possible with such an arrangement to claim the benefits of any tax agreement that may exist between the second State and the third country.

* In the preparation of this paper, the United Nations Secretariat had the assistance of Pierre Kerlan, sous-directeur, Direction générale des impôts, Ministère des finances, Paris.

* Code général des impôts (Paris, Imprimerie nationale), art. 158 (1).
(c) Salaries and wages, non-commercial income

In this category, the types of income that can most easily escape taxation are:

First, remuneration derived abroad in payment for services, such as technical studies or advice, fees received abroad for occasional work, and payments to managers or partners of foreign firms;

Secondly, payments made in one State to a resident of another in the form of pensions or annuities.

Such income, if it is not taxed at the source, is apt to escape taxation both in the State where it is acquired and in the country where the recipient is domiciled.

(d) Interest, dividends

It is probably in this field that tax evasion is greatest, since interest and dividends can easily be collected anonymously at a financial institution in a third country where the securities are held in custody. This category of income also lends itself to many fraudulent practices through the skilful use of certain special provisions of domestic law. Thus, certain institutions whose prime purpose is economic or financial are frequently used to facilitate tax evasion.

In this connection, the situation created by investment trusts (fonds de placement) and holding companies respectively will be discussed below.

Investment trusts are pools, lacking juridical personality, whose purpose is to manage a portfolio of securities belonging to third parties (individuals or companies). The rights of the owners are represented by certificates issued by the trust, generally in bearer form.

The anonymity of the owners of the securities held by the trust is assured by the form of the certificates and also by the fact that the trust has no liability towards the tax administration of the country in which it is established. Since the trust is not itself a taxable entity, it pays no tax on profits from its dealings or on income. The bearers of the certificates who are the true recipients of the profits and income, are not subjected to personal taxation, since the tax administration is not aware of their identity. The preferential tax régime applied in some countries to holding companies also encourages the respect of the income which it receives and redistributes; and, secondly, from the total lack of information as to the identity of the individuals or companies among whom the distributions are made.

(e) Royalties

Royalties paid abroad for the use of or the right to use patents or trade marks often bears no reasonable relation to the value of the use or right in question. Profits are often transferred in this way in order to take maximum advantage of the most favourable tax provisions (no taxation at the source and lower taxation in the recipient's State).

3. Means available to the French tax administration

French tax legislation contains many provisions which give the administration responsible for tax assessment wide powers to carry out checks anywhere in the country. Moreover, this administration has been organized in such a way that it can exercise its powers effectively. Normally, no property, no transaction, no income derived or earned in France should escape checking by the administration. Obviously, however, for practical reasons, and particularly owing to shortage of staff, such checking can be neither complete nor perfect. The extensive means available to the administration consist of the documentation in its possession, its investigatory powers and the obligations imposed on the taxpayers.

(a) Documentation available

In order to establish various taxes and carry out checks, either on the basis of documents or on the spot, France has a documentation system that is divided into two main parts: the taxpayer's file; special documentation concerning real estate and banking accounts.

The taxpayer's file is of special importance for checking on the basis of documents or on the spot. It is kept at the taxpayer's local tax office, irrespective of whether the taxpayer is an individual or a body corporate. The file contains all the available information on the taxation of the individual or the body corporate in whose name it is kept.

The file is divided into three main parts.

The first part, or "annual file", contains information on the preceding assessment year. It includes, in addition to the return of taxable income or corporate earnings and, where applicable, the monthly or quarterly return in connexion with the value-added tax, special returns (or extracts therefrom) filed by third parties concerning wages, fees, royalties, interest and dividends paid to the taxpayer in whose name the file is kept.

The annual file may also contain information about the taxpayer received from other tax centres. This latter category of information is especially important in the case of an individual company on a business or a professional activity outside the area covered by the tax office. In such cases, a special file is also kept in the local tax office for the place where the business or other activity is carried on. Companies and individuals reporting business income must attach to their annual return of profits various material, such as the working account, the profit-and-loss account, the balance-sheet and schedules of amortization of funds placed in reserve, whether or not deducted in computing the incomes of capital gains or losses and of extra-budgetary adjustments. This information must be given on special forms which follow the usual pattern of accounting nomenclature.

In addition, companies must send to the administration copies of the minutes and proceedings of the board of directors and the general meetings of shareholders, a statement of dividends paid or of any other amount made available to shareholders, and a statement of dividends received from foreign sources. Taxpayers' replies to queries from the inspector or to requests for additional information are also placed in the "annual file".

After assessment is completed, the annual file is left in the taxpayer's general file, so that all returns for the period not yet subject to statutory limitation are available for purposes of comparison or for any later check on the basis of documents or on the spot.

The second part of the general file, known as the "permanent file", contains information of permanent value for checking returns. The main sources of the information assembled here are extracts from the returns filed by heirs or legatees for the assessment of succession duties which include a list of the items constituting the assets and liabilities of the estate, and extracts from contracts and legal instruments produced to the tax authorities for the formality of registration. A copy of these extracts, prepared either by the tax administration or by notaries and court officials, is placed in the permanent file of each heir, legatee or party to the contract.

A permanent file thus contains:

(a) Documents relating to property: extracts from instruments of sale of real estate, information on the construction and demolition of buildings, extracts concerning the division of estates, marriage contracts, rentals, farm tenancies, loans, purchases of shares or of interests in partnerships and so forth;

Individuals are required to report, on their income-tax return, the ownership of certain possessions which are considered external signs of wealth.

In places where the tax offices dealing with direct and indirect taxes respectively have not yet been merged, the office for indirect taxes keeps a special file on taxpayers liable to the turnover. It is estimated that by the end of a five-year programme, scheduled to be completed in 1975, these two units, together with some parts of the existing local registry unit, will have been merged throughout the country.
(b) Documents relating to business or professional activities, such as the declaration of existence which bodies corporate liable to the company tax are required to sign in the month in which they are established, articles of association, increases and reductions of capital, notices relating to the establishment, modification or transfer of an enterprise or of goodwill or to the extent of the taxpayer's capital, notices relating to the establishment, modification or transfer of an enterprise or of goodwill or to the extent of the taxpayer's capital, notices relating to the establishment, modification or transfer of an enterprise or of goodwill or to the extent of the taxpayer's capital, notices relating to the establishment, modification or transfer of an enterprise or of goodwill or to the extent of the taxpayer's capital, notices relating to the establishment, modification or transfer of an enterprise or of goodwill or to the extent of the taxpayer's capital, notices relating to the establishment, modification or transfer of an enterprise or of goodwill or to the extent of the taxpayer's capital. Some of this information is provided automatically by other departments; for instance, the essential information on motor-car registration cards is sent to the tax administration by the issuing authorities. In other cases, the information is obtained either during special investigations or when checking the affairs of other taxpayers, whether individuals or companies.

The third part of the general file contains a summary of information on the tax assessment: amount of the tax and date on which it was established; proposed adjustments; requests for clarification or additional information; fines and fiscal penalties imposed on the taxpayer.

The special documentation consists of two main elements:

(a) Documentation concerning real estate. This includes documents relating to the market value and rental value of buildings and land. Where the tax offices dealing with assessment and with checking have been merged, this information is classified topographically in the case of urban communes and alphabetically by name of the owner in the case of rural communes. Such information is of great value in assessing succession duties or registration duties, as well as in checking on the income tax owed by individuals, in that it makes possible a better appraisal of their style of living or their expenses. If necessary, the very considerable documentation held by two specialized units of the tax administration—the cadastral survey and the registry of mortgages—is also used. In assessing and checking taxes on income and the turnover tax, tax inspectors may also avail themselves of the schedule of companies liable to the business tax (contribution des patentes), together with the factors on which the tax is based (rental value of premises and size of payroll) and the schedule of persons liable to the occupancy tax (contribution mobiliere). The latter is particularly important, in that it is comparable to a continuing census of persons—French nationals and others—who have a residence in France. This information relating to local taxation can be used in assessing State taxes, since local taxes are assessed and administered by the State on behalf of the local authorities;

(b) The index of bank accounts. An index is kept in each departement of the bank accounts and custody accounts for securities opened with banks or their branch offices and with similar institutions in the departements. These indexes are kept by alphabetical order of the names of the account-holders, and a national card index is now being prepared from them. By consulting such an index, tax inspectors are able to keep track of any bank account opened by a taxpayer, if necessary, they can then obtain from the banks details of the transactions recorded in the account.

(b) Means of investigation

The tax administration has general authority to require that accounting records and many other documents should be produced to it in order to provide it with the information needed in assessing and checking all taxes based on declared income. This authority is known as the right to discovery. It has a broad scope and can be used both to check an enterprise's returns by examining its own books and to search the books and accounting records of enterprises as a means of checking the returns of third parties. Thus, the accounting records of taxpayer A may be examined for the purpose of checking the fiscal situation of taxpayer B, as well as that of taxpayer A himself.

In this connexion, it should be noted that the French tax administration has general authority to check taxpayers' returns within the period not yet subject to statutory limitation (the preceding four years). It may check the return either on the basis of documents—that is, the checking is done from the office, by correspondence, after a thorough examination of the return and of the information in the file—or by auditing the accounts, in which case the auditor checks the taxpayer's accounting records at the head office of the enterprise. Audits may be undertaken of company profits, business income, non-commercial income or agricultural income which is taxable according to the actual profits, and, lastly, in connexion with turnover taxes.

The audit powers given to officials of the tax administration are subject to only a few restrictions, as follows:

At the start of the proceedings the taxpayer must be notified of his right to be assisted by an adviser of his choice;

In the case of enterprises with a turnover of less than 1 million francs (commercial enterprises) or 250,000 francs (other enterprises), the audit may not take more than three months;

After completion of an audit, the tax administration cannot again audit the enterprise for the same period and the same taxes; however, tax officials are still entitled to search the enterprise's accounts for information relating to the same period in order to verify or check the returns of a third party.

Three kinds of information may be obtained through the exercise of the right to discovery:

(a) The tax administration may exercise this right with respect to local authorities, departements and communes, national enterprises, and depositaries of official archives and registers, especially notaries and court officials. Thus, tax officials may obtain information on import or export transactions or the registration of pleasure-boats from the Customs Administration, on purchases of private aircraft from the Air Transport Administration, on the staff employed by the taxpayer or on the fees collected by members of the medical professions from persons covered by social insurance from the Social Security Administration, on racehorses from the stud-book, etc.

(b) The judicial authorities must inform the tax administration of any indication they may have that an attempt has been made to commit fraud. In addition, the courts may communicate the papers in civil or criminal cases to the tax administration. After the completion of every proceeding, the papers in the case remain on deposit with the clerk of the court, at the disposal of the tax administration, for 15 days. This enables the tax administration to review the pleadings of counsel and statements by experts, bailiffs, receivers in bankruptcy, etc.

(c) The tax administration is entitled to examine the accounting records of private enterprises. This includes not only the books themselves, but supporting documents, such as invoices, inventories, bank statements, shipping documents, correspondence etc. The right to discovery is generally exercised with respect to companies, individuals liable to tax under the actual income system because of their business, non-commercial or agricultural income, and enterprises liable to the turnover tax. The tax administration's authority extends not only to the supporting documents for the years not yet subject to statutory limitation, but to the books and documents for the current year.

In the case of companies, the right to discovery includes stock transfer registers and the attendance lists for the general meetings of shareholders. The right to discovery is exercised primarily for the purpose of checking enterprises themselves, but it can also be used to verify the fiscal situation of third parties or other enterprises. One particular use of these rules allows tax officials to examine bank statements. Any individual body corporate, or any
entity which is subject to the right to discovery, must make his or
its books and files available to the tax administration and must
allow the tax inspector to make copies of or take extracts from all
the data examined.

(c) Obligation to file a return
Third parties are required to complete a number of formalities in
order to supply the tax administration with documents that, when
cross-checked, make it possible to verify taxpayers’ returns.

Parties making payment of income
Employers, payers of pensions, banks and the like are required
to declare to the tax administration the amounts paid out during
the year in respect of salaries, wages, pensions, annuities, fees,
copyrights or royalties and income from movable capital.

Certain institutions
The social security institutions responsible for the reimbursement
of medical expenses incurred by persons covered by the social
welfare schemes are required to inform the tax authorities of fees
collected directly by doctors, dentists and medical auxiliaries. Banks
are required to inform the tax authorities of every new account
and to check the identity of the customer. The same applies to
over-the-counter payments of dividends or interest on bearer
securities to individuals (see table given below).

<table>
<thead>
<tr>
<th>Returns required of taxpayers by the French tax authorities for the purpose of cross-checking</th>
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<tbody>
<tr>
<td><strong>Return</strong></td>
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<tr>
<td>-------------------------------------------------</td>
</tr>
<tr>
<td>Wages paid</td>
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<tr>
<td>Pensions and annuities</td>
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<tr>
<td>Commissions, brokerages, rebates, fees</td>
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<tr>
<td>Copyrights or royalties</td>
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<tr>
<td>Income from securities</td>
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<tr>
<td>Remuneration of partners and distributions of profits</td>
</tr>
<tr>
<td>Proceeds of fixed-income investments (interest on bonds, loans, debt-claims, notes of indebtedness etc.)</td>
</tr>
<tr>
<td>Loan contracts between individuals</td>
</tr>
<tr>
<td>Proceeds of long-term savings contracts</td>
</tr>
<tr>
<td>Opening and closing of accounts</td>
</tr>
<tr>
<td>Sales other than retail sales</td>
</tr>
</tbody>
</table>

List of customers making wholesale purchases, date and amount of purchase. This information is given only on request by the administration.
Penalties and sanctions

All individuals and legal entities, whether taxpayers or not (see column 2 of the preceding table) must file returns with the tax administration. Failure to do so, or late filing, is punishable by a fiscal fine of 25 francs for each document not filed or filed late.\(^4\)

Any omission or misstatement found in these documents is also punishable by a fine.\(^5\)

Obligations of taxpayers leaving France

A taxpayer domiciled in France who transfers his domicile abroad is required to file, not more than 10 days before applying for a passport, a provisional return of the income he has received during the year of his departure up to the date of departure.

Should the change of domicile involve removal of household effects, the Customs Administration also requires the production of a certificate stating that direct taxes have been paid.

Obligations of taxpayers domiciled abroad

Persons who have no residence in France, but are liable to French tax, are required to file a detailed return of all their income from French sources with the inspector for the place where their principal interests in France lie.\(^7\) The deadline for filing such returns is later than the deadline for taxpayers generally. It varies according to the country in which the person is domiciled. These persons must also, within 30 days of a request by the tax assessment unit, designate a representative in France authorized to receive communications concerning the assessment and collection of the tax and any dispute arising therefrom.

B. INTERNATIONAL CO-OPERATION WITH RESPECT TO TAXATION

1. General considerations

(a) Double taxation and administrative assistance

There is a traditional principle which holds that national tax administrations take no notice of each other and that enforcement orders for the collection of taxes are devoid of all authority beyond the frontiers of the State in whose behalf the taxes to be collected were instituted. In this respect, tax law differs from general law; judicial decisions in civil cases, for example, carry some authority in other countries and may, under certain conditions, be made enforceable in those countries.

This strict confinement of the fiscal authority of each State to its own borders encourages tax evasion. The purpose of agreements concerning reciprocal assistance with respect to taxation is precisely to curb this total independence, so that tax evasion and tax fraud may be limited or prevented. From the theoretical viewpoint, the problem of international assistance with respect to taxation is both distinct from and related to the problem of preventing double taxation.

Thus, it is quite conceivable in theory—and it happens in practice—that two Governments may agree to render assistance to each other for the prevention of tax evasion and tax fraud carried out on an international scale without, however, considering it necessary to conclude at the same time a convention for the elimination or the reduction of double taxation.

Consider the hypothetical case of two States both of which have introduced a personal-income tax applicable to income from all sources, payable only by persons domiciled in the respective territories of these States and assessed without any limitation on the aggregate income from any source of the taxpayers concerned. Consider, in addition, that the two States apply an identical definition of fiscal domicile. Clearly, in such a situation, there is no possibility of overlap between the two taxes, and there would accordingly be no point in drawing up an agreement for the elimination of double taxation. But it is equally apparent that each State, lacking the means which would enable it to ascertain the existence and the amount of income derived by its own taxpayers from the foreign country, may suffer from cases of evasion and fraud which its domestic legislation is powerless to combat; the two Governments therefore have the strongest reasons to enter into negotiations with a view to arranging for the closest possible reciprocal collaboration between their tax administrations.

However, the hypothetical example cited above is seldom encountered in reality. In practice, the problems outstanding between two fiscal sovereignties usually relate to double taxation and to evasion in respect of the resources that may be taxed.

The fact is that double taxation is one of the major causes of taxpayers resorting to deception and fraudulent schemes in order to avoid at least one of the taxes, the combined burden of which they find intolerable. However, the habit of fraud, once acquired, even for relatively respectable reasons, may well outlast the abnormal circumstances which fostered its creation and growth. In other words, when two States whose Governments are desirous of eliminating double taxation to which their taxpayers are liable conclude an agreement for that purpose, restricting the exercise of their concurrent fiscal sovereignties, there is reason to fear that those affected, while reaping the full benefit of the measures taken in their behalf, may not agree voluntarily to desist from the now deplorable practices which previously enabled them to avoid legal inequities. Thus, there is clearly a connexion, albeit very general and of a psychological nature, between the two problems. Technical considerations frequently have the effect of strengthening this connexion. The point to note is that agreements in recent years have tended all too clearly to generalize the rule of linking the item to be taxed to the State of the taxpayer’s domicile. As others have pointed out, this trend is in keeping with the very concept of an income tax, since it is only when money or value is in the hands of its recipient—the person directly or indirectly liable for the tax—that it may properly be called income; the same applies to taxes on fortune, the latter being generally conceived of and imposed as a supplement to and an adjusting factor for income taxes.

In practice, however, consistent enforcement of tax assessment is dependent on the relevant tax administration’s having at its disposal, first, reliable means of investigation to ascertain the existence of taxable resources and check the amount or value thereof; and, secondly, ways of enforcement offering adequate assurances that its tax claims can be collected in the event of passive or active resistance on the part of delinquent taxpayers. It is clear that such means of investigation and enforcement can readily be made available to the administration by domestic legislation when the resources to be taxed are situated in the territory of the country concerned, but that they are usually lacking when the tax is assessed on property or income outside that territory.

Thus, generalization of the rule of linking the item to be taxed to the State of the taxpayer’s domicile has the effect—all other things being equal—of increasing the proportion of property and income not subject to any direct action by the administration responsible for assessing and collecting the tax. Each time that a double-taxation agreement removes the tax on a particular class of income in the State of its source and leaves standing only the tax levied in the State of the recipient’s domicile, the State which can most easily effect collection is precluded from doing so, and the burden is placed on the State for which collection is most difficult.

This being so, it is understandable that Governments concluding double-taxation agreements very often consider it necessary to add to their conventions accessory provisions spelling out the basis for co-operation between their respective administrations, and even between their judicial organs, in the investigation and collection of those taxes in respect of which double taxation has been avoided. The scope of administrative assistance with respect to taxation between two countries may vary according to the political will of their Governments. Agreements concerning such assistance may

\(^4\) Code général des impôts, art. 1725.
\(^5\) Ibid., art. 1726.
\(^7\) Ibid., arts. 10 and 170.
be limited to the normal implementation of conventions for the avoidance of double taxation. Other countries, however, may agree to exchange information with a view to preventing tax fraud in general. The reluctant attitude adopted by some States is due in part to their privileged position, which is reflected in their low taxes or in their adoption of measures which tend to make them "tax havens".

(b) Historical development

It may be of interest to note that the first international tax treaty was an agreement concerning reciprocal administrative assistance between France and Belgium, signed on 12 August 1843. Shortly thereafter, Belgium signed similar agreements with two other States, the Netherlands and Luxembourg (1845).

The League of Nations first began work on tax questions pursuant to two recommendations, one from the International Financial Conference at Brussels (1920) and the other from the International Economic Conference at Genoa (1922). The first Conference stated that it "considers it well to draw attention to the advantages of making progress under each of the following heads: an international understanding which, while ensuring the due payment by everyone of his full share of taxation, would avoid the imposition of double taxation which is at present an obstacle to the placing of investments abroad" (recommendations of the Brussels Conference on resolution No. 12 proposed by the Commission on International Credits and on resolution No. 13 proposed by the International Financial Commission of Brussels).

The Genoa Conference had recommended that the League of Nations should study international measures for the prevention of tax evasion. The recommendation was worded as follows:

"We have considered what action, if any, could be taken to prevent the flight of capital in order to avoid taxation, and we are of the opinion that any proposals to interfere with the freedom of the market for exchange, or to violate the secrecy of bankers' relations with their customers are to be condemned. Subject to this proviso, we are of the opinion that the question of measures for international co-operation to prevent tax evasion might be usefully studied in connection with the problem of double taxation."

The Financial Committee entrusted the study of the two questions of double taxation and tax evasion to a group of high officials of the fiscal administrations of various countries. Following the submission of the general report to the Financial Committee,8 an enlarged Committee of Experts prepared a model draft Convention on Administrative Assistance in Matters of Taxation and another draft Convention on Judicial Assistance in the Collection of Taxes.9

The General Meeting of Government Experts (1928) reviewed the draft Conventions.1 The Fiscal Committee of the League of Nations, established on 14 December 1928, drew attention in several of its reports to the desirability of simultaneously concluding treaties to settle the problems of both double taxation and tax evasion.

At its meeting on 9 October 1936, the Assembly of the League of Nations asked the Fiscal Committee to consider the problem of tax evasion. One part of the 1936 report1 deals with existing practices of tax evasion, with particular reference to general income tax. The report proposes a new solution based on the exchange of information and asks whether States would be prepared to agree to a general convention establishing such a system for the exchange of information. The response was unfavourable. Nevertheless, at its sessions at Mexico City (1943) and London (1946), the Committee decided to consider the several problems involved and to prepare separate model conventions on reciprocal assistance in matters of taxation.

For our purposes, it will be most useful to refer to the London Model Convention, which is the more comprehensive; this text is entitled: Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Taxes on Income, Property, Estates and Successions: London Draft.10

The Convention for which the text was proposed as a model was assumed to be concluded between two States which would simultaneously bind themselves by means of treaties concerning double taxation with respect to taxes on income and property and with respect to taxes on estates and successions.

This is clear from article I of the draft, which reads as follows:

"With a view of assuring, in the interest of Governments and taxpayers, an effective and fair application of the taxes to which apply the Conventions for the Prevention of Double Taxation of Income and Estates and Successions, concluded this day by the contracting States, each of the contracting States undertakes, subject to reciprocity, to furnish on special request such information in matters of taxation as the competent authorities of each State have at their disposal or are in a position to obtain under their own revenue laws and as may be of use to the competent authorities of the other State in the assessment of the above-mentioned taxes and to lend assistance to the competent authorities of the other State in the collection of such taxes."

As concerns the activities of the Organisation for Economic Co-operation and Development (OECD), it should be noted that the Fiscal Committee was somewhat reluctant to tackle the problem of administrative assistance. The Model Convention makes absolutely no reference to the repression of tax evasion and tax fraud. It does include one article relating simply to the exchange of information, but contains no provision concerning assistance in the collection of taxes.

As concerns the exchange of information, it is stipulated, in article 26 of the Preamble to the OECD Model Convention, that:

"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 Parties 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 (ordre public)."


\footnotetext{10} League of Nations, Report of the Fiscal Committee to the Council on the Work of the Sixth Session of the Committee, document C.430. M.266. 1936.II.A.
Paragraph 1 specifies that the competent authorities are to exchange such information as is necessary for the proper carrying out of the Convention and of the domestic laws concerning taxes covered by the Convention. Information is to be exchanged only in so far as the national tax in question is covered by the Convention and the taxation is in accordance with the Convention.

2. Conditions and limits of assistance with respect to taxation

When conflicts of laws arise, the application of the foreign law which would govern a particular legal relationship is, of course, restricted by many exceptions, the most important of which is that arising out of the concept of public policy; similar provisions and restrictions limit the application of treaty provisions whereby States undertake to render assistance to one another in the assessment and collection of taxes.

The authors of the London Model Convention proposed:

"Article V"

Special requests for information and/or assistance for the enforcement of taxes under articles II and IV of the present Convention may be refused in the following cases:

A. If they involve the obligation to obtain or supply information which is not procurable under the legislation of the State applied to or that of the applying State;

B. If they imply administrative or judicial action incompatible with the legislation and practice of either contracting State;

C. If compliance involves violation of a professional, industrial or trade secret;

D. If the request relates to a taxpayer who is a national of the State applied to;

E. If, in the opinion of the State applied to, compliance with the request may compromise its security or sovereign rights."  

"Article VI"

When the competent authorities of one of the contracting States have requested from the authorities of the other State information to which this Convention applies, they shall observe secrecy as regards such information, in the same way and to the same extent as is done in the State that supplies it, and the competent authorities of the former State shall apply to its officials the administrative and penal sanctions that correspond, under its own laws, to the violation of such secrecy."  

It is stipulated, under the terms of the Model Protocol of the London Convention, that:

"Article VII"

No request for assistance for the collection of taxes shall be formulated when:

A. There is a presumption that the amount due is in fact recoverable in the interested State;

B. The amount due is less than..." (an amount to be decided upon in the currency of each contracting State).

"Article VIII"

Assistance procedure shall be in the form for which the laws of the State applied to provide, as stipulated in the Convention. Nevertheless, any special forms of assistance not being incompatible with the laws of the State applied to may be adopted at the request of the applying State.

"Article IX"

Revenue claims for collection shall not receive preference over either public or private claims in the State applied to.

"Article X"

The authorities of the State applied to shall take all such steps and employ all such means of action as they would be bound to take and employ in similar cases, when their own interests are involved, provided that no means of action shall be employed to which there is no corresponding means of action under the law of the applicant State. In doubtful cases, the competent authorities of the applicant State must certify that their national legislation empowers them to comply with a similar request from the State applied to.

"Article XVI"

"The Convention shall not apply to measures of conservancy in respect to taxes that have not yet been assessed."  

(a) Application of the agreement

The inclusion of the exchange of information clause in agreements makes it possible for the agreement to be consistently applied. The question arises whether, in the absence of such a provision, the competent authorities may require evidence from the taxpayer before applying the provisions of the agreement, particularly as regards exemption from or reduction of withholding taxes on certain types of income. Such evidence is required of the taxpayers themselves, who can thus take a considered decision on whether it is in their interest to seek to benefit from the agreement. Some States grant exemption from or reduction of their own tax only if the recipient of the income in question produces evidence of actual taxation in the other State. Such formalities may be required in the absence of any express provision concerning assistance with respect to taxation.

In the normal course of implementation of the agreement, the competent authorities of one State may request the assistance of the tax authorities of the other contracting State. For instance, in the case of royalties, tax administrations may request information concerning the identity of the recipient with a view to establishing whether there is any special relationship between the payer and the recipient which would enable the amount of the royalties to be contested.

Information concerning the prices fixed between two enterprises in two different contracting States, or between a permanent establishment situated in one country and its head office in another, may be very useful to tax administrations in deciding on the proper allocation of taxable profits between two related enterprises or in adjusting the amount of profits as between a permanent establishment and the head office of an enterprise.

Similarly, for the purpose of applying the effective rate of tax, administration of the country of the taxpayer's domicile may request the administration of the other State to inform it of the amount of income which originates in its territory and which, under the agreement, it has the exclusive right to tax.

Exchanges of information of this kind make possible the normal implementation of agreements.

(b) Reciprocity

The condition of reciprocity is strictly construed where assistance with respect to taxation is concerned, and it has a number of consequences which should be mentioned here. The condition of reciprocity is, moreover, related to the concept of secrecy in tax matters. In particular, as concerns assistance in assessment the obligation assumed by each State towards a foreign State constitutes a serious departure from the principles which, in most countries, govern secrecy in tax matters, and such a departure cannot be conceded without a pledge of equivalent assistance from the other State party to the agreement. This is why reciprocity is strictly required in all agreements, without exception.

A request for assistance in assessment (a request for information pertinent to the determination of tax liability) can be entertained only to the extent that the information sought is obtainable under the laws of both parties—the applicant State and the State applied to.

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Ibid., p. 109.
Ibid., p. 111.

Ibid., pp. 117 and 121.
On the one hand, the laws of the State applied to must permit such investigation: a tax agreement cannot impose on taxpayers obligations exceeding those provided for in the laws to which they are subject; furthermore, it would be inconceivable that a State should, on behalf of another Government, employ means of inquiry or of fraud prevention which it would lack if it were acting on its own behalf.

On the other hand, the laws of the applicant State must, in similar circumstances, provide the same or equivalent opportunities of investigation; it is here that the concept of reciprocity comes into play, since the two contracting States must be on a footing of strict equality in an area where each in turn will be the applicant and the party applied to. Consequently, the application of measures of assistance with respect to assessment is limited to the exchange of such information as is obtainable under the more restrictive of the two sets of laws.

It should be noted in this connection that the domestic legislation of many States protects the banker's duty of secrecy, which can even be invoked against the national tax administration.

It remains to consider the rule of reciprocity according as the agreement includes provisions for the exchange of information on request or as a matter of routine.

In the first case, requests for information relating to specific cases may be made between tax administrations, which are thus in a position to determine, with respect to each individual request, whether the condition of reciprocity has been fulfilled. The tax authorities may also decide between themselves whether reciprocity will be regarded as fulfilled globally in respect either of a given category or of all the assistance measures that are provided for in connexion with a given tax, on the understanding that the more restrictive interpretation must apply.

Article II of the London Model Convention provides as follows:

"The competent authorities of each of the contracting States shall be entitled to obtain through direct correspondence, from the competent authorities of the other contracting State, information concerning particular cases that is necessary for the assessment of the taxes to which the present Convention relates."

In the second case, the tax authorities may arrange to exchange automatically information which comes into their possession in the normal course of their administrative practice. The arrangement between them should specify the kind of information to be exchanged in this manner. The arrangement should be made on the basis of strict reciprocity by category or by type of information. Consequently, the scope of such a procedure varies considerably from agreement to agreement, since the structure of information systems varies from State to State according to the powers of their tax administrations and the obligations imposed on the taxpayers.

The condition of reciprocity is considered to be fulfilled entirely in cases where information is exchanged as a matter of routine; within this limit, neither contracting State can use that condition as an excuse for failing to carry out the specific obligations it has assumed.

In any event, the routine exchange of information, where stipulated, is the most effective procedure for assistance in reviewing tax assessments. Under this procedure, each State is supplied with information concerning taxable resources or events giving rise to tax liability the existence of which it might not even have suspected, so that it would have been quite unable to set in motion the machinery for exchange of information on request.

The London Convention provides for routine assistance:

"Article III

"In accordance with the preceding article, the competent authorities of each contracting State shall transmit, in the ordinary course as soon as possible after the expiration of each calendar (or fiscal) year, to the competent authorities of the other State:

"A. The name and address of any individual, partnership, corporation or other entity having an address in the territory of the former State and deriving from sources within the territory of the former State rents, dividends, interest, royalties, income from trusts, wages, salaries, pensions, annuities or other fixed or determinable periodical income, indicating the amount of such receipts in the case of each addressee;

"B. An extract of the inventories received by the competent authorities in the case of property passing on the decease of persons that had an address in the territory of the other State or the nationality of that State;

"C. Any particulars which the competent authorities may obtain from banks, insurance companies, or other financial institutions concerning assets and claims belonging to persons having an address in the territory of the other State;

"D. Any particulars which the competent authorities may obtain from inventories in the case of property passing on death concerning debts contracted to, or property passing to, persons having an address in the territory of the other State."

In the case of collection, as in the case of assistance in the assessment of taxes, the principle of reciprocity should constitute the basis.

The purpose of clauses concerning assistance in collection is to authorize the administrative, and possibly the judicial, authorities of each contracting State to collect the tax claims of the other State, amicably or even through enforcement procedures.

Collection must not be effected by any acts or methods of enforcement which are not provided for in the laws of both the State applied to and the applicant State. Agreements should not have the effect of providing the applicant State, outside its frontiers, with methods of enforcement which are not available to it in its own territory; moreover, it is inconceivable that the tax administration in the State applied to should employ on behalf of a foreign Treasury procedures or methods of enforcement that are not applicable to the collection of its own tax claims.

Agreements may stipulate that the rules to be applied in effecting collection shall be those in force in the State applied to; no doubt the negotiators of such conventions believed at the time that the methods of collection provided for by their respective national laws were equivalent, thus obviating the need for the competent authorities to satisfy themselves of reciprocity in each individual case.

(c) Tax secrecy

The laws of most States embody a rule concerning tax secrecy which is binding on the tax administration.

In French domestic law, article 2006 of the General Tax Code releases the administration from the obligation of secrecy only in its dealings with the financial administrations of the Overseas Territories and the States of the Community, and with any States which have concluded an agreement with France concerning reciprocal assistance in respect of income tax.

Since tax agreements concluded by France, when duly ratified by the parliament, outrank domestic laws, they may validly enable the French administration to communicate to foreign administrations information which is in its possession or which it may obtain in the exercise of its right to discovery or its investigatory powers, not only with respect to income tax, but for the enforcement of other taxes covered by the agreements.

\footnote{Ibid., p. 107.}
Because, however, it represents a departure from normally sanctioned practice, the transmittal of information must be subject to guarantees establishing the conditions and the limits of such transmittal.

Any State receiving information under provisions concerning assistance in assessment must, in respect of such information, observe the rules of administrative secrecy. This obligation to maintain secrecy is, under all tax laws, a condition governing the granting of special investigatory powers to the administration responsible for tax inspection; accordingly, any restriction imposed in one State on the use which may be made of documents relating to taxation must be respected by any other contracting State to which such documents are communicated.

Information transmitted to a foreign tax administration must be communicated only for purposes of assessment and collection of taxes covered by the agreement and, if expressly so provided, for the purpose of avoiding tax fraud. It follows that the foreign administration may use such information to contest the bases on which taxes are claimed from its taxpayers, either at the purely administrative level or before the courts.

The foreign administration must not, however, transmit such information to other departments responsible for the enforcement of other laws (exchange control legislation, price control regulations, etc.). Similarly, information transmitted by foreign administrations to the General Tax Division may not be used in connexion with violations of exchange control regulations. Any prosecution in such circumstances should be recognized by all judicial and administrative authorities as void for reasons of public policy.

There is no doubt that the administrations of many States scrupulously respect the principles of legality, including, in particular, tax secrecy. However, some newly independent States, whose administrative structures are weak and which suffer from a shortage of qualified officials, do not always respect the principles of legality and prosecute certain taxpayers for violations of various regulations, as well as for breaches of the tax laws, on the basis of information communicated by foreign administrations. In such an event, the latter may take the view that there has been a breach of treaty provisions and may accordingly reconsider the arrangements that were made with regard to the exchange of information.

(d) Public policy

Clauses concerning assistance with respect to taxation also embody a second category of conditions or restrictions, based on the concept of public policy. This is not the place for an analysis of that concept, which in international law has, of course, a very special meaning and variable limits, sometimes narrower and sometimes broader than those placed on it in domestic law.

Suffice it to mention the major clauses in agreements relating to assistance with respect to taxation which appear to be motivated by a desire to safeguard international public policy. Obvious examples of this are provisions concerning the protection of business secrecy (trade, banking, industrial or professional secrets).

It is stipulated in various conventions that the exchange or transmittal of information that would be of value in tax enforcement may be refused if the communication of such information to foreign authorities might jeopardize the secrecy in question. Such a restriction cannot be accounted for in terms of the concept of reciprocity. As was seen above (section B, 2 (c)), in most agreements the clauses relating to secrecy in matters of taxation prohibit the administrative departments which receive information from disclosing or communicating it to anyone who is not concerned with the assessment, investigation or collection of taxes. Accordingly, if a tax administration has any business secrets in its possession as a result of the exercise of its normal investigatory powers, the fact that it communicates such secrets to the tax administration of a Contracting State should not, in principle, lead to their disclosure.

The above-mentioned clauses can therefore be accounted for only by the instinctive mistrust which exists between States, even between "twin" administrations, and by the concern of each of the Governments involved to protect its nationals from any risk of indiscretion.

Public policy is also occasionally invoked in tax agreements in order, for instance, to prohibit the communication of information which might jeopardize the security or the "general" interests of the Contracting States.

(e) Exclusion of assistance against nationals

The greatest restriction imposed on the application of clauses relating to assistance in matters of taxation is, however, the proviso that assistance is to be refused if the request relates to a national of the State applied to. Can it be that the origin of this restriction is to be found in a special form of protection of "public policy" in the broad sense? According to this interpretation, the aim of each State, in refusing to assist foreign administrations against its own nationals, would be indirectly to retain first claim on the taxable resources of its nationals.

In the view of the present writer, the explanation is simpler, being of a psychological and political nature; clauses relating to assistance in matters of taxation are almost always incorporated in double-taxation agreements, and it will be generally accepted that such agreements, the main purpose of which is to improve the situation of taxpayers in the Contracting States by eliminating duplication of tax, should not be used to aggravate that situation. Since the legislative power in each country derives from an electorate which does not include resident aliens, this restriction is provided solely for the benefit of nationals, who have the right to vote and whose representatives must approve the treaties that are concluded. It should, however, be pointed out that this restriction generally applies only to assistance in collection. In cases of dual nationality, the individual concerned may not rely on his double allegiance as a defence against measures of assistance between the two countries.

3. General rules

(a) Assistance in assessment

By way of exception to the rule concerning secrecy, with respect to taxes, including income taxes, laid down in article 206 of the General Tax Code, the administration is authorized to exchange information with the financial administrations of the Overseas Territories and the States of the Community, and with any States which have concluded an agreement with France concerning reciprocal assistance in respect of income tax. Information is exchanged either on request or as a matter of routine, in accordance with the procedures and subject to the limits laid down in the international agreements for the avoidance of double taxation which have been concluded with the countries concerned. In the case of routine exchanges of information, the principle is merely affirmed in most of these agreements, which leave the detailed listing of the types of information involved to be worked out later in an arrangement between the competent authorities of the two countries. However, arrangements of this kind have in fact been concluded with only a few of the countries concerned, so that the extent of routine exchanges of information is thus far relatively limited. Moreover, the scope of the arrangements is in many cases narrower than that of the international agreements on which they are based.

In all cases, information is exchanged between the central administrations; local offices are not authorized to communicate directly with each other.

It should be pointed out that, as a general rule, requests for information can be received and complied with only if the applicant administration indicates precisely: the identity of the taxpayers who are under investigation; the nature and, where necessary, the location of the property or income to which the investigations relate.

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* See France, Council of State, 13 March 1968, req. 66801: Droit fiscal, 1969, No. 9, commentary 314, conclusion Mehli; restriction on the use of information in connexion with prosecution for a non-fiscal offence: traffic in narcotic drugs.
Thus, it would not be in order, under an agreement providing for the exchange of information only in request and not as a matter of routine, to request, for example, a list of persons owning property of a given kind or receiving income of a given kind, or a list of the property or income of a specified person.

On the other hand, requests for information on such matters as the following will be permissible: the amount of income received by Mr. X (identity specified) in respect of a certain building (location specified) or certain securities (held in custody by . . . or issued by . . .); the domicile of Mr. X, who has received certain specified income.

It follows that the procedure of exchanging information on request varies considerably in effectiveness, according as the agreement to be implemented also provides or does not provide for the exchange of information as a matter of routine.

Where the agreement provides both for routine exchange of information and for exchange on request, the latter form of assistance in assessment is an indispensable complement to the former and the aggregate of the measures taken enables a systematic check to be made; in practice, specific requests for information will refer to documents already transmitted as a matter of routine and will be aimed at obtaining additional details regarding the information contained in those documents; in this way, errors will be rectified, omissions made good and cross-checks carried out much more readily, since the previous routine exchanges of information will have enabled both countries to constitute basic files.

If, on the other hand, provision is made for the exchange of information only on request in particular cases, the effectiveness of exchanging information will be appreciably reduced, and all that will be possible through this procedure will be test checks of the actual or assessed amount of taxable resources, the existence of which is already known to the applicant administration.

(b) Assistance in collection

The purpose of clauses concerning assistance in collection is to authorize the administrative, and possibly the judicial, authorities of each Contracting State to collect the tax claims of the other State amicably, or even through enforcement procedures.

It is provided in article IV of the Mexico City and London draft Conventions that:

1. The competent authorities of each of the Contracting States shall be entitled to obtain, through direct correspondence, the assistance and support of the competent authorities of the other Contracting State for the collection of the taxes to which the present Convention relates together with interest, costs, additions to taxes, and fines not being of a penal character, according to the laws of the State applied to, in the case of taxes that are definitely due according to the laws of the applying State.

2. In the case of a request for the enforcement of a tax, revenue claims of each of the Contracting States which have been finally determined shall be accepted for enforcement by the other Contracting State and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes.

3. The request shall be accompanied by such documents as are required by the laws of the applying State to establish that the taxes are definitely due.

4. If a revenue claim is not definitely due, the State applied to may, on the request of the other Contracting State, take such measures of conservancy as are authorized by the revenue laws of the former State for the enforcement of its own taxes.

In order to ensure the collection of taxes, tax administrations have at their disposal means and privileges which are not available to ordinary creditors for the purpose of obtaining payment of amounts owed to them. The methods of and safeguards for collection available to the Treasury are established by law; and, like all extraordinary measures, they must be strictly applied. A State may not therefore take action to collect a tax claim of another State unless the former State is expressly authorized to do so in an international agreement duly ratified and published so that the agreement is applicable vis-à-vis individuals.

Normally, assistance in collection is provided for in the case of taxes which are no longer subject to appeal; a request submitted by a State must be accompanied by documents establishing that, under the laws of that State, the tax claims to be collected are final. However, in the case of taxes which may still be appealed against, the agreement may stipulate that the State applied to shall take measures of conservancy.

The collection of foreign taxes must be effected in accordance with the applicable laws of the State applied to. Some agreements provide that the claims of the applicant State shall enjoy the same safeguards and privileges as those of the State applied to. In this case, therefore, the tax claims are treated as identical in every respect to those of the Treasury of the State applied to.

The State to which the tax is owed may not, of course, request the assistance of another State unless all domestic remedies have been exhausted, especially as regards legal proceedings against the property or debt-claims of the delinquent taxpayer within its own territory. Accordingly, when the State applied to intends to institute proceedings on behalf of the applicant State, the taxpayer concerned must be entitled to obtain a stay of proceedings if he is able to establish title to property situated in the applicant State to establish claims on persons domiciled in that State.

C. CO-OPERATION BETWEEN FRANCE AND FOREIGN STATES

List of countries having concluded agreements with France

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<th>With respect to taxes on income</th>
<th>With respect to succession duties</th>
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<tr>
<td>Monaco</td>
<td>18 May 1963</td>
<td>18 May 1963</td>
<td>18 May 1963</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>30 December 1949</td>
<td>30 December 1949</td>
<td>30 December 1949</td>
<td></td>
</tr>
<tr>
<td>Niger</td>
<td>1 June 1965</td>
<td>1 June 1965</td>
<td>1 June 1965</td>
<td></td>
</tr>
<tr>
<td>Norway</td>
<td>22 September 1953</td>
<td>22 September 1953</td>
<td>22 September 1953</td>
<td></td>
</tr>
<tr>
<td>Pakistan</td>
<td>22 July 1966</td>
<td>22 July 1966</td>
<td>22 July 1966</td>
<td></td>
</tr>
<tr>
<td>Saar</td>
<td></td>
<td>31 December 1953</td>
<td>31 December 1953</td>
<td>Annex IV to the Franco-German Treaty on the Settlement of the Saar Question of 27 October 1956</td>
</tr>
<tr>
<td>Senegal</td>
<td>3 May 1965</td>
<td>3 May 1965</td>
<td>3 May 1965</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>8 January 1963</td>
<td>8 January 1963</td>
<td>8 January 1963</td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>24 December 1936</td>
<td>24 December 1936</td>
<td>24 December 1936</td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>9 September 1966</td>
<td>9 September 1966</td>
<td>9 September 1966</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>22 May 1968</td>
<td>22 May 1968</td>
<td>22 May 1968</td>
<td>Implementation procedure pending</td>
</tr>
</tbody>
</table>

In so far as they concern death duties, the provisions of this annex remained in force after 5 July 1959, the date of reincorporation of the Saar into the Federal Republic of Germany.
1. Co-operation in the application of agreements

Agreements generally contain provisions relating to exchanges of views between the competent authorities of the Contracting States concerning the interpretation or application of the agreement. These provisions constitute a basis for joint action in designing the various standard forms to be used to facilitate application of the agreement, particularly with regard to dividends, interest and royalties (the application of reduced rates, and procedures for exemption from or refund of foreign taxes).

 Provision may also be made for direct communication between the competent authorities of the Contracting States in a mixed commission, with a view to facilitating the settlement of any difficulties that might arise in the application and interpretation of the agreement.

In addition, attention is drawn to some very novel provisions for co-operation which were included in the Franco-Swiss Convention of 9 September 1966 in order to prevent certain kinds of tax evasion. In particular, these measures enable the benefits of the Convention to be withheld both from persons who are only the apparent recipients of the income and from certain companies which are in fact controlled by non-Swiss interests.

2. Exchange of information on request

Treaty provisions concerning administrative assistance in respect of assessment provide for exchanges of information either on request or as a matter of routine, according to the procedures and within the limits broadly laid down in the agreement in question.

Exchanging information on request is of rather limited value, because of the vital difference in the effectiveness of this procedure according as the agreement in question also provides or does not provide for the exchange of information as a matter of routine.

Where information can be exchanged both as a matter of routine and on request, the second form of assistance in the assessment of taxes is an indispensable complement to the first, and the sum total of the resulting information may be such as to permit systematic tax checks. In such circumstances, a specific request for information can be aimed primarily at obtaining additional details regarding information already communicated as a matter of routine through which, if necessary, errors may be rectified or omissions made good.

If, on the other hand, information can be exchanged only on request in particular cases, the effectiveness of the procedure may be too limited. All it can do, as a rule, will be to facilitate test checks of the actual or assessed amount of taxable resources the existence of which is already known to the requesting administration, since it presupposes that the latter has already initiated an investigation and has carried it far enough to be able to formulate a precise request on a specific point.

Information relating to specific cases is exchanged only on request with the following countries: Algeria, Belgium, Cameroon, Canada, Central African Republic, Comoro Islands, Congo, Dahomey, Federal Republic of Germany, Greece, India, Israel, Italy, Ivory Coast, Lebanon, Luxemburg, Mauritania, Norway, Pakistan, Spain, Switzerland, United Kingdom, Malawi, Rhodesia, Zambia.

The agreements concluded with a number of States provide for the exchange of information as a matter of routine, but it has not yet been possible to spell out the arrangements for this. Accordingly, administrative assistance is rendered only on request in the case of the following States: Algeria, Cameroon, Central African Republic, Comoro Islands, Congo, Dahomey, Greece, Israel, Italy, Ivory Coast, Lebanon, Mauritania, Norway, Spain.

The Franco-Japanese Convention does not contain any provisions concerning administrative assistance. Hence, no request for information can be lodged with the taxation authorities of Japan, even in very special circumstances.

Lastly, the convention signed with Ireland, the implementation procedure for which is still pending, provides for the exchange of information either as a matter of routine or on request, but the routine exchange procedure depends on the conclusion of an agreement between the two States.

3. Exchange of information as a matter of routine

As was indicated above (see section C, 2), the exchange of information as a matter of routine, which is the broadest form of assistance, does not necessarily exclude requests for further details regarding particular cases when the information transmitted is not adequate to ensure effective checking.

According to the present status of agreements with respect to taxes on income, information is actually exchanged as a matter of routine with the countries indicated below. The conditions for and limits of such assistance, and the practical procedures for preparing and transmitting information schedules for foreign tax administrations, are the subject of special instructions.

One may first list the countries in respect of which the exchange of information applies in principle to income of any kind derived by individuals domiciled, or bodies corporate established, in the country:

- In respect of all classes of income other than those for which exchange as a matter of routine has actually been arranged (see section C, 3).
- Usually salaries, wages, pensions and annuities, income from securities, income from immovable property, royalties on the use of patents, trade marks and manufacturing processes or formulae, directors' fees. It should be noted that, in the case of some countries, debts contracted in France by residents of the countries concerned should also be reported on information schedules.
### Country Agreement providing for exchange

<table>
<thead>
<tr>
<th>Country</th>
<th>Agreement providing for exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>Convention of 8 October 1959, article 22; arrangement of 14 April 1962, article 1</td>
</tr>
<tr>
<td>Chad</td>
<td>Agreements of 3 June and 20 July 1959</td>
</tr>
<tr>
<td>Denmark</td>
<td>Agreement of 8 February 1957, article 23; arrangements of 13 November 1958 and 9 February 1959</td>
</tr>
<tr>
<td>Finland</td>
<td>Convention of 25 August 1958, article 22; arrangements of 3 January and 31 December 1959</td>
</tr>
<tr>
<td>Gabon</td>
<td>Agreement of 21 April 1966; exchange of letters of 11 May 1967 and 3 July 1967</td>
</tr>
<tr>
<td>Madagascar</td>
<td>Convention of 29 September 1962, article 37; decision of 9 August 1967; exchange of letters of 12 April 1965 and 9 March 1966</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Agreement of 30 December 1949, article 22; exchange of notes of 30 December 1949</td>
</tr>
<tr>
<td>Niger</td>
<td>Agreement of 1 June 1965; exchange of letters of 11 May 1967 and 16 July 1968</td>
</tr>
<tr>
<td>Senegal</td>
<td>Agreement of 8 May 1965; exchange of letters of 11 May 1967 and 10 January 1969</td>
</tr>
<tr>
<td>Sweden</td>
<td>Agreement of 24 December 1936, article 18</td>
</tr>
<tr>
<td>United States of America</td>
<td>Pending the implementation of the provisions of article 26 (3) of the new Agreement of 28 July 1967, information schedules are prepared and transmitted in accordance with the procedures provided for in the instruction relating to the Agreements and Protocol of 18 October 1946 and 17 May 1948.</td>
</tr>
<tr>
<td>Upper Volta</td>
<td>Agreement of 11 August 1965; exchange of letters of 11 May 1967 and 26 July 1967</td>
</tr>
</tbody>
</table>

In the case of the Federal Republic of Germany and Luxembourg, the routine exchange of information applies to certain categories of persons resident in those countries and/or to certain categories of income:

<table>
<thead>
<tr>
<th>Country</th>
<th>Agreement providing for exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany (Federal Republic)</td>
<td>Frontier workers (excluding amounts of remuneration)</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Wages, salaries and other remuneration paid to frontier workers Copyrights, income from patents, royalties and the like</td>
</tr>
</tbody>
</table>

In the case of the United Kingdom, the routine exchange of information relates to: interest on debt claims; income from securities; pensions and annuities; rents, royalties pertaining to immovable property and income from the letting or placing under management of a business.

4. Assistance in collection

Some of the agreements concluded by France with respect to taxes on income and succession taxes include measures for administrative assistance designed to facilitate the collection of taxes. In view of the extraordinary nature of the service rendered by the State applied to in collecting within its territory the tax claims of the applicant State, the extent and modalities of application can be laid down only in a formal agreement.

In order, therefore, to appreciate the exact scope of the assistance in collection which is provided for, one must refer in each specific case to the text of the article making provision for it. It may, however, be noted that the assistance clauses included in agreements now in force generally provide for enforced collection in accordance with the laws applicable in that matter in the State applied to. Unless the text states otherwise, it is generally agreed...
that the claims to be collected enjoy the privileges or other safeguards provided for in similar matters by the domestic legislation of the State in question.

List of States with which provision exists for assistance in collection.

<table>
<thead>
<tr>
<th>Country</th>
<th>Article of the agreement* providing for assistance in collection</th>
<th>Income tax</th>
<th>Succession tax</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>40</td>
<td>40</td>
<td></td>
<td>Assistance not yet arranged</td>
</tr>
<tr>
<td>Austria</td>
<td>23</td>
<td>23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>21</td>
<td>15</td>
<td></td>
<td>Claims to be collected do not enjoy any privileges</td>
</tr>
<tr>
<td>Denmark</td>
<td>24</td>
<td></td>
<td></td>
<td>Claims to be collected do not enjoy any privileges</td>
</tr>
<tr>
<td>Finland</td>
<td>23</td>
<td>10</td>
<td></td>
<td>Claims to be collected do not enjoy any privileges</td>
</tr>
<tr>
<td>Germany</td>
<td>23</td>
<td>23</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greece</td>
<td>24</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>25</td>
<td></td>
<td></td>
<td>Claims to be collected do not enjoy any privileges</td>
</tr>
<tr>
<td>Lebanon</td>
<td>38</td>
<td>38</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Luxembourg</td>
<td>23</td>
<td></td>
<td></td>
<td>Claims to be collected do not enjoy any privileges</td>
</tr>
<tr>
<td>Madagascar and French-speaking African States</td>
<td>38</td>
<td>38</td>
<td></td>
<td>Applicable to the collection of taxes duties and debt claims of whatsoever nature</td>
</tr>
<tr>
<td>Monaco</td>
<td>23</td>
<td>12</td>
<td></td>
<td>Applicable to all taxes</td>
</tr>
<tr>
<td>Norway b</td>
<td>24</td>
<td></td>
<td></td>
<td>Claims to be collected do not enjoy any privileges</td>
</tr>
<tr>
<td>Sweden</td>
<td>20</td>
<td>8</td>
<td></td>
<td>Claims to be collected do not enjoy any privileges</td>
</tr>
<tr>
<td>United States of America b</td>
<td>27</td>
<td>12</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* The dates of signature of the agreements are given in the Column 2 of the table entitled "List of countries having concluded agreements with France ", which appears in section C of this annex.

6. Agreements concluded with French-speaking African States

The agreements concluded by France with the States which emerged from the former French Union include provisions for administrative assistance with regard to both assessment and collection.

(a) Exchange of information

In regard to the exchange of information relating to the assessment of taxes, the provisions of the agreements present no particular novelty as compared with agreements concluded with other States, but their scope is particularly wide.

The article relating to such exchanges provides that "the taxation authorities of each State shall communicate to the taxation authorities of the other State any fiscal information available to them and useful to the latter authorities to ensure the proper assessment and collection of the taxes to which the Agreement relates and the enforcement with respect to such taxes of the statutory provisions concerning the prevention of tax fraud ".

"Information shall be exchanged as a matter of routine or on request in connexion with particular cases. The competent authorities of the two Contracting States shall agree on the list of classes of information to be communicated as a matter of routine ".

These texts apply to assessment and to the prevention of fraud, but only in respect of the taxes to which the agreements relate, i.e., taxes on income, succession duties and registration taxes, to the exclusion, in particular, of other direct taxes and taxes on turnover. Exchanges of information on request are effected between tax administrations on the initiative of either one of them, but in practice they are very infrequent and concern only a certain number of specific cases.

The exchange of information as a matter of routine has been instituted with only a few countries. Most of the African States have retained in their tax laws provisions similar to those which enable the French administration to obtain information of all kinds relating to taxpayers. Consequently, the principle of reciprocity is respected and the administrative arrangements which have been concluded provide for a very full list of classes of information to be communicated as a matter of routine.

For instance, the French administration has an obligation to forward the following information to the Malagasy tax administration:

- Stipends, salaries, wages, bonuses and other similar emoluments
- Copyright royalties and income from the sale or grant of licences for the use of patents, trade marks, secret processes and formulae and the hire and use of cinematographic films or industrial, commercial or scientific equipment and information;
- Income from immovable property and agriculture, and royalties pertaining to the working of mines, quarries or other natural resources;
- Stipends, salaries, wages, bonuses and other similar emoluments or remuneration, pensions and annuities;
- Industrial and commercial profits;
- Income derived from a profession or from any other independent activity;
- Directors' percentages, attendance fees and other emoluments received by members of the boards of directors or supervisory boards of French companies;
- Income from French securities (earnings from shares, corporate stock, bonds and other negotiable certificates of indebtedness) and assimilated income;
- Interest and other income from debt claims and deposits of any kind.
With respect to the succession duty, the following information or documents concerning the composition of estates left by deceased persons domiciled in Madagascar or including property taxable in Madagascar:

Copies of lists supplied by government departments, institutions or agencies subject to governmental supervision, companies, bankers, officers of the courts or business agents, being depositaries, holders or parties liable for the payment of certificates of indebtedness, sums of money or securities forming part of the estate;

Advices of the opening of joint accounts with the depositaries indicated in the preceding subparagraph, and lists supplied by the liable parties of certificates of indebtedness, sums of money or securities standing to the credit of the joint holders of such accounts at the time of the death;

Certificates of registration of inventories, official records (procès-verbaux) or other declaratory instruments concerning property forming part of the estate;

Copies of declarations by the heirs, signed in France, concerning estates left by persons domiciled in Madagascar or including property taxable in Madagascar.

With respect to registration taxes other than succession duties:

Certificates of registration of corporate instruments relating to companies whose registered offices are situated in or have been transferred to Madagascar;

Certificates of registration of instruments effecting mergers, split-offs or partial contributions to the assets of companies, where the new or absorbing company or companies, or the company or companies to which the contributions are made, have their registered offices in Madagascar;

Certificates of registration of instruments of any kind relating to immovables or businesses situated in Madagascar.

Provisions of this kind are currently in force only with Madagascar (convention of 29 September 1962), the Niger (agreement of 1 June 1965) and the Upper Volta (agreement of 11 August 1965). Negotiations are under way with some other States with a view to the adoption of similar measures.

While the exchange of information is thus somewhat limited, the same is not true with respect to assistance in collection.

(b) Assistance in collection

The agreements concluded by France with French-speaking African States include the following provisions under the terms of the Convention between France and Malagasy of 29 September 1962:

"Article 38"

"1. The Contracting States agree to lend each other reciprocal assistance and support with a view to the collection, in accordance with the provisions of their respective laws or regulations, of the taxes to which this Convention relates and of any tax increases, surcharges, overdue payment, penalties, interest and cost pertaining to the said taxes, where such sums are finally due under the laws or regulations of the requesting State.

"2. Requests for assistance shall be accompanied by such documents as are required under the laws or regulations of the requesting State as evidence that the sums to be collected are finally due.

"3. On receipt of the said documents, writs shall be served and measures of recovery and collection taken in the requested State in accordance with the laws or regulations governing the recovery and collection of its own taxes.

"4. Tax debts to be recovered shall enjoy the same safeguards and privileges as similar tax debts in the requested State."

"Article 39"

"In the case of tax debts still subject to appeal, the taxation authorities of the creditor State may, in order to safeguard the latter's rights, request the competent taxation authorities of the other Contracting State to take such interim measures as its laws or regulations permit."

"Article 40"

"The measures of assistance specified in articles 38 and 39 shall also apply to the recovery of any taxes and duties other than those to which this Convention relates, and, in general, to all debt-claims of whatsoever nature of the Contracting State."

These provisions are supplemented by an exchange of letters dated 14 May 1965 between the signatories of the French-Malagasy Convention mentioned above, defining and limiting the scope of collection:

"Articles 38 to 40 of the Tax Convention between France and Madagascar signed at Tananarive on 29 September 1962 provide for measures of reciprocal assistance with a view to the collection of the taxes to which the Convention relates, of all other taxes and duties and, in general, of all debt-claims of whatsoever nature outstanding in either Contracting State.

"In order that the application of the above provision may not give rise, in certain cases, to difficulties of procedure and in order to preserve the atmosphere of confidence which exists between the Governments of our two countries, I have the honour to propose that where, in application of the provisions of the above-mentioned articles 38 to 40 proceedings are instituted against a taxpayer in either of our respective States for the recovery of taxes or debts owed in the other State, the taxpayer shall be entitled to request the competent authorities of the first-mentioned State to stay such proceedings if he is able to establish title to property situated in the State in which the tax in question was assessed or to establish a claim on a public or quasi-public authority of the said State.

"If the request, which must be supported by the necessary documents, appears to be justified, the application of the provisions of article 38 shall be stayed. The competent authorities of the requesting State shall be informed of that decision and the request shall be submitted within three months to the mixed commission referred to in article 41 for examination. That commission shall decide whether, and to what extent, the measures of enforced recovery shall proceed.

"In more general terms, disputes relating to collection shall be deemed to be difficulties of application within the meaning of article 41 of the Convention.

"I should be greatly obliged if you would inform me whether this proposal is acceptable to your Government."

Letters couched in identical terms were also exchanged in connexion with the agreements concluded with other African States. Agreements laying down the procedures for assistance with regard to collection have also been concluded.

One may cite here the Convention of 2 June 1960 concerning relations between the French Treasury and the Malagasy Treasury and reciprocal assistance and co-operation between the Malagasy Republic and the French Republic with respect to the organization and operation of Treasury services:

"Article 9"

"Payments and collections relating to warrants issued by the competent French authorities the payment or collection of which is to be effected within the territory of the Malagasy Republic shall be centralized by the French Paymaster in Madagascar. Where the payments or collections are to be effected by Malagasy accounts officers, the Treasurer-General of Madagascar shall countersign the warrants and forward them to the competent Malagasy accounts officers.

"Payments within the territory of the Malagasy Republic as referred to in the preceding paragraph shall be effected, whether by the French Paymaster or by Malagasy accounts officers, in
In the case of tax debts still subject to appeal, the taxation authorities of the creditor State may request the competent taxation authorities of the other State to take interim measures in accordance with article 39 of the Convention.

However, the recovery of fines and monetary penalties imposed by the courts can be effected only through extrajudicial representations, since the Agreement concerning Co-operation in Judicial Matters between the French Republic and the Malagasy Republic of 27 June 1960, published in the Journal Officiel of 20 July 1960, makes no provision for the recovery of such debt-claims through judicial action.

Moreover, the geographical scope of the Convention of 29 September 1962 is limited, in accordance with article 1 (paragraph 2), to metropolitan France and the overseas départements. It follows that: first, all that can be done about Malagasy debt-claims in the French Overseas Territories is for the French accounts officers to make extrajudicial representations to the debtors; secondly, collection warrants issued by the public authorities or institutions of the French Overseas Territories cannot give rise to enforced recovery in the territory of the Malagasy Republic.

It should be noted that, where proceedings are instituted against a taxpayer in one State for the recovery of taxes or debts owed in the other State, the taxpayer is entitled to request the competent authorities of the requested State to stay such proceedings if he is able to establish title to property situated in the other State.

Recovery of debt-claims of the Malagasy Republic in French territory is effected in the following manner as concerns the transmittal of warrants and the transfer of amounts collected.

Before transmitting warrants to French accounts officers, the Paymaster attached to the French Embassy at Tananarive must satisfy himself that each warrant has been drawn up in accordance with the Malagasy regulations applicable to the category of debt-claims involved and that the supporting documents accompanying it are sufficient to enable the French accounts officer to take measures for recovery.

Malagasy accounts officers may transmit non-enforceable warrants to French accounts officers. Whenever a warrant of this kind is submitted to him for transmittal to French accounts officers, the Paymaster attached to the French Embassy must omit from the instructions the word "enforceable".

Should a warrant appear to the French accounts officer responsible for recovery to be not in order or to lack adequate supporting evidence, he must immediately return the warrant to the Paymaster attached to the French Embassy in Madagascar. The same applies where attempts at recovery prove unsuccessful in the case of warrants which can be collected only through extrajudicial representations to the debtors.

Amounts collected on behalf of Madagascar are transferred to the Paymaster attached to the French Embassy at Tananarive. Such transfers are accompanied by statements giving all relevant particulars concerning the collection warrants in cases of partial recovery or by the warrants themselves where they have been collected in full.

As concerns the collection of warrants, the means employed are as follows. Where requests for assistance have been submitted in due form, the French accounts officers who receive the corresponding Malagasy collection warrants must take immediate measures for the recovery of the amounts concerned in accordance with the laws and regulations applicable to French debt-claims of a similar nature. The Malagasy debts to be recovered enjoy the same safeguards and privileges as similar French tax debts under the terms of articles 38 and 40 of the convention.

Article 41 of the convention of 29 September 1962 and the annexed exchange of letters of 14 May 1965 laid down specific provisions for cases disputed by debtors.

Where a taxpayer shows proof that he has suffered double taxation in respect of the taxes to which the convention relates, he may make application to the competent French authorities.
or to the competent Malagasy authorities. Should the application not be considered admissible by the French taxation authorities as concerns French taxes, they may contact the competent Malagasy authorities and, if necessary, bring the matter before the mixed commission provided for in article 41, paragraph 3, of the convention. The initiation of this procedure does not interrupt the process of recovery; however, if the debtor has requested a stay of proceedings, the rules applicable to French taxes as regards security to be furnished by the taxpayer in order to ensure possible later recovery of the debt are applied.

The fourth paragraph of the exchange of letters of 14 May 1965 stipulates that: “In more general terms, disputes relating to collection shall be deemed to difficulties of application within the meaning of article 41 of the Convention.”

This provision relates to all disputes arising in connexion with the adoption of measures for the recovery of a Malagasy debt-claim and thus concerns disputes relating to procedures for the assessment of tax debts or for the settlement of other debts, as well as disputes in connexion with collection as such.

In the same manner as applications concerning double taxation, debtors, claims relating to the assessment of taxes and stating the grounds for the claim may be addressed to the competent financial administration, which may take the matter up with the Malagasy authorities and, if necessary, bring it before the mixed commission. The process of recovery is not interrupted, unless a stay is granted and security is furnished.

Debtors’ claims relating to the assessment of other debts—including debt-claims in respect of matters other than taxes and property—and stating the grounds for the claim are transmitted to the competent authority in order that it may, if appropriate, take the matter up with the Malagasy authorities and, if necessary, bring it before the mixed commission.

In such cases, unless otherwise instructed, there is a temporary stay of recovery proceedings.

Concerning disputes relating to recovery as such, the main grounds for debtors’ claims are in this connexion that the debt-claim is already subject to statutory limitation or that payment has already been made in full or in part.

In the case of debt-claim already subject to statutory limitation, the papers relating to the claim are forwarded for examination to the French Paymaster at Tananarive. If the Malagasy authorities uphold the claim, the demand for payment is returned to the Paymaster Paymaster. Otherwise, the accounts officer notifies the debtor of the information received from the Malagasy authorities and calls on him to pay his debt. If the debtor maintains his claim, the papers relating to the case are transmitted to the competent French authority, which, if necessary, brings the matter before the mixed commission; the stay of recovery proceedings is then continued, and the accounts officer may, if he has not already done so, take interim measures.

In the case of debt-claims which have already been paid, and upon presentation of the receipt issued by the Malagasy accounts officer who received payment or of any other reliable evidence, the French accounts officer temporarily stays the recovery proceedings and notifies the French Paymaster at Tananarive accordingly, with a view to obtaining from the Malagasy authorities confirmation that the debt has been settled. Depending on the reply from the Malagasy authorities, the procedure indicated above is followed.

Where the debtor is unable to provide proof of payment, the recovery proceedings are continued; however, the accounts officer responsible for recovery notifies the French Paymaster at Tananarive, furnishing all relevant particulars concerning the manner in which the debtor claims to have paid his debt. If the French Paymaster confirms the debtor’s position, the recovery process is interrupted and the demand for payment is returned to Tananarive.

The second and third paragraphs of the exchange of letters of 14 May 1965 provide that where, in application of the provisions of articles 38 to 40 of the convention, proceedings are instituted against a taxpayer in France, the taxpayer shall be entitled, provided that he furnishes the necessary supporting documents, to request the French authorities to stay such proceedings if he is able to establish title to property situated in Madagascar or to establish a claim on a public or quasi-public authority of that State.

Since persons from whom payments are due to the Malagasy authorities and who invoke the protection of this provision must furnish the necessary supporting documents to the French accounts officer responsible for recovery, two cases may arise: no supporting documents are submitted; in this case, the recovery proceedings are continued; supporting documents are submitted; the documents furnished to the Treasury accounts officers are forwarded by them, together with the papers relating to the debt-claim, to the competent French authority and the recovery proceedings are temporarily stayed.

After requesting the French Paymaster in Madagascar, if necessary, to contact the competent Malagasy authorities with a view to assessing the validity of the documents submitted, the competent French authority requests the Treasury accounts officer to resume recovery proceedings, if the supporting documents are not recognized as valid; gives the accounts officer confirmation of the stay of proceedings if the claim is upheld; in this case, the Malagasy authorities will be informed that the application of the provisions of article 38 of the convention are suspended and that the case is being referred to the mixed commission.

Where the Paymaster attached to the French Embassy has occasion to arrange for Malagasy accounts officers to effect collection of warrants forwarded to him for this purpose through accounts officers of the French Treasury, he is required to countersign the warrants and forward them to the Malagasy Treasury services only if they are accompanied by the necessary supporting documents. If a warrant does not fulfill these conditions, the Paymaster must contact the authorizing accounts officer with a view to having it put in order.

Collection of claims of the French Treasury within the territory of the Malagasy Republic by means of extrajudicial representations may be effected either by the Paymaster attached to the French Embassy or, at his request, by the Malagasy accounts officer for the place of residence of the debtor or the place where the property is situated. In the event of enforced recovery, however, proceedings may be instituted only by the competent Malagasy accounts officer. The Paymaster attached to the Embassy transfers the amounts of French claims recovered in Madagascar to the Treasury accounts officers.

Thus, co-operation between the French tax administration and those of the French-speaking African States is very extensive so far as collection is concerned, since it applied to all the debt-claims of a State, i.e., not only to taxes other than those to which the agreement relates, but also to various kinds of debts such as damages. This close collaboration is possible because of the similarity of the powers of the financial administrations of all these States; the common language, which facilitates the transmittal of documents, and the frequent exchanges of officials belonging to these administrations. As a result of this co-operation, movements of income and capital between these States and France is closely supervised and tax evasion is thus rendered very difficult. The bilateral relations with France will be complemented by exchanges between the African States themselves upon the entry into force of the multilateral Convention which they have signed.

7. Measures for the more effective prevention of international fraud

(a) Changes in domestic legislation

In view of the existing administrative practices and documentation relating to tax assessment and inspection, it may be considered that
the French administration is sufficiently informed about income from French sources and about property situated in France to limit tax evasion satisfactorily at the domestic level. By way of example, one may note the ethical effect on the French fiscal system of the Act of 12 July 1965, which grants a tax credit to certain holders of French securities. In order to avail themselves of this benefit, recipients of income from securities of the type coming under the Act are forced to include the amount of such income in their tax returns. Thus, fraud is automatically eliminated. On the other hand, French law does not provide for such strict checks on income earned abroad or on property situated abroad. The information needed for ascertaining income from foreign sources can normally be obtained only from the tax administration of the source country.

However, in order to improve domestic legislation relating to the taxation of foreign income, the tax administration of the country in which a person is domiciled can adopt a number of fiscal and non-fiscal measures.

Non-fiscal measures

The main non-fiscal measure is exchange control. However, this is, by definition, an exceptional action which may be rendered necessary by a monetary crisis, but which cannot be contemplated for exclusively fiscal reasons. Exchange control, when instituted, makes possible the effective prevention of certain types of fraud. In such circumstances, movements of foreign currency are generally subject to prior approval and to the existence of supporting evidence, so that payments of dividends and interests to non-residents must be justified by the possession of shares or debt-claims.

Similarly, the payment of royalties is subject to the furnishing of proof that they bear a reasonable relation to the value of the use or right involved. Payment for purchases from abroad and for export sales must be effected on the basis of normal prices. Similar action can be taken in respect of movements of capital for investment. This can prevent the creation of holding companies, where they are not required by considerations of management.

If the establishment of a holding company abroad is approved, the administrative decision can require, as a *quid pro quo*, that the income of the holding society should be repatriated in order to preclude its accumulation outside the country.

Fiscal measures

With a view to the more effective prevention of international fraud, changes can be made in domestic tax laws, but any such action may quickly reach its limit, partly because the means employed are manifestly disproportionate to the objectives sought or the results obtained.

Domestic legislation could be adjusted so as to shift the burden of proof, which normally falls on the tax administration. Such a reform would apply to all transactions involving residents and non-residents which might provide a cover for fraud. The following may be mentioned in this connexion: payments of any kind to holding companies established abroad which carry on no profit-earning activity; royalties paid abroad for the use of or the right to use patents or trade marks; remuneration for the provision of services such as studies, technical advice or administrative assistance; interest; remuneration paid to persons domiciled or allegedly domiciled in countries where there is no income tax, especially directors' fees and allowances.

French legislation includes provisions based on such considerations, but they apply only to companies between which there is a relationship of dependence (article 57 of the General Tax Code). Experience has shown that these provisions, which are of great value, can only seldom be utilized.

The point is that any of the transactions listed in the preceding paragraph may sometimes provide a cover for fraudulent scheming, but then again they may be perfectly in order. Consequently, it is not possible to apply systematically what is necessarily a complex control procedure.

What might, however, be contemplated is the enactment of legislation excluding payments in the above-mentioned categories to persons enjoying a privileged tax status abroad (holding companies and untaxed individuals) from the expenses which are deductible for tax-assessment purposes, where no supporting evidence is furnished. The monitoring of income from securities by means of a dividend schedule is another example of the limitations of unilateral fiscal action. The dividend schedule is one of the best means of preventing fraud in respect of taxes on income from securities and succession duties on estates which include securities. Although France makes effective use of this system, there are major obstacles to the adoption of similar measures by other countries, and this limits its significance for the prevention of fraud at the international level.

(b) International co-operation

Close co-operation among States would make it possible to combat tax fraud or tax evasion much more effectively. Such cooperation would take the form of joint administrative action in various fields where unilateral action, such as the traditional treaty assistance, proves inadequate. Psychologically, a public declaration by a number of States of their refusal to acquiesce in the growth of international fraud and of their common determination to take action to reduce its scope would undoubtedly produce great effects.

The adoption of such a stand would impel States which now acquiesce in irregular fiscal practices to reconsider their position. More generally, it might induce States which earnestly believe in fiscal justice and are resolved to apply the necessary measures to join the group which first took the initiative. The practical expression of such co-operation would be an improvement in exchanges of information and a broadening of the scope of routine exchanges.

Improvements in exchanges of information

In order to be of any value, the exchange of information for the purpose of preventing tax fraud or tax evasion must be capable of disclosing the existence of taxable assets and their nature or value. An exact knowledge of income from foreign sources which should be taken into consideration for tax purposes requires, firstly, that States themselves should have sources of documentation and effective means of investigation in respect of all persons, entities of every kind, companies (including banks) established in their territory. It also requires that administrations should be in a position to check the validity of deductions of expenses incurred abroad for the purpose of acquiring or conserving such income. To that end, existing agreements with respect to assistance should be improved by producing a broader and more precise definition of their scope and by standardizing and simplifying the practical procedures to be applied. It is clear, however, that such improvements, both substantive and procedural, would require the existence in each Contracting State of comparable conditions in law and in fact with regard to availability of the information to be exchanged and direct access to sources of information.

The availability of information depends on there being clear-cut obligations on third parties responsible for the payment of items of income, whether directly (employers) or indirectly (banks, financial institutions). There can therefore be no improvement in the present situation unless such obligations are imposed or expanded. In France, the situation in this respect may be regarded as satisfactory. Apart from the returns required automatically of anyone holding funds or items of income for the account of third parties, officials of the tax administration have very extensive powers of investigation. This right to discovery may be exercised, *inter alia*, vis-à-vis banks and similar institutions, so that information concerning bank-account transactions can be obtained, no matter what the source of income of the persons concerned may be (see section A, 3).

In some other countries, secrecy regarding transactions carried out by financial institutions, commercial and savings banks and similar entities is the rule. Only in very limited cases may exceptions
be made in favour of the tax administration, with the consent of the owner of the funds, securities or income in question.

Broadening of the scope of routine exchanges

Arrangements are seldom made in practice for the exchange of information as a matter of routine, which is the most effective means of combating tax fraud. Routine exchanges should therefore be enlarged in scope and extended systematically to all information normally in the possession of the tax authorities. However, the initiation of such fiscal assistance can be achieved only if the participating countries adopt a global approach to reciprocity as concerns both the exchanges themselves and the benefits afforded, so that each State can take advantage of all the investigatory powers of the others, even if those powers are not strictly equivalent in all the areas in which they are exercised. Such a scheme also presupposes a broad interpretation of the traditional saving clauses concerning business secrecy.

In general, it should be possible for information obtained in the ordinary course from a foreign country under arrangements concerning administrative assistance provided for in an agreement to be utilized in the requesting country in the same manner as information obtained directly by its own tax authorities. Such utilization vis-à-vis taxpayers or third parties or before the courts should not be subject to any limitations other than those which may derive from the rules of tax secrecy. Fiscal assistance might also be improved through a relaxation of the rules now observed by certain States with regard to banking secrecy.

Although any such relaxation is primarily a matter for the public authorities of the State in which the establishments concerned are situated, provision might be made at the international level for exceptions, strictly limited to the requirements of the tax authorities for purposes of tax assessment and supervision. The information thus obtained could be used only by tax officials, who are themselves bound to professional secrecy vis-à-vis all outsiders.

Such provisions could not fail to facilitate tax assessment in the country where the bank concerned is situated. They would also make it possible to arrive at agreements which would improve international fiscal ethics. Treaty provisions can unquestionably help to diminish the effects of banking secrecy, in so far as the State in which such a rule exists accepts the inclusion of provisions ruling out any conjunction between the practice of banking secrecy and the application of the agreement. Such an arrangement may have a certain deterrent effect, in that the maintenance of anonymity deprives recipients of income of the advantages afforded by the agreement in question. Of course, the greater the difference between the treatment accorded to declared recipients of income and to anonymous recipients, the greater will be the deterrent effect. In this regard, the system of tax credits instituted in France by the Act of 12 July 1965 is helping, by its progressive extension to residents of countries with which France has entered into diplomatic agreements, to increase appreciably the ethical effect of tax agreements in the field of taxes on dividends.

Practical consequences

Broadening the scope of fiscal assistance in the manner proposed would require each State to set up proper organizational arrangements. Tax administrations would have to establish a service, an agency or a special unit with the necessary resources and powers to manage the provision of assistance to fellow administrations. These services should have the authority to centralize the documents to be transmitted to other States and to carry out the inquiries and investigations necessitated by requests from other States. These specialized services should make it possible to reduce considerably the present delays in exchanges of information and would provide a framework for the consideration of problems relating to international fraud and a source of information, experience and documentation for each of the countries concerned.

The effectiveness of such an arrangement might be reinforced by the permanent presence of an accredited correspondent from each of the fellow administrations who could inform the tax authorities of the State to which he was seconded about the investigatory resources of the State he represents and about the most effective type of action that could be requested where information on specific cases was sought. There would also have to be collaboration between the tax administrations with a view to their keeping each other informed of the results of their auditing operations, so that they might learn the main types of fraud employed and means of detecting them. It would be of general utility for administrations to transmit to each other periodically, on a theoretical plane, the results of their research in tax surveillance. This new type of co-operation should, in the first place, make it possible to be better and more speedily informed of the constantly changing techniques employed by the practitioners of fraud and thus act more promptly to put an end to their use, either by supervisory measures or by special legislative provisions. Secondly, it would provide the means for beginning to build up the kind of international documentation which is essential to the prevention and punishment of tax evasion and fraud in their most sophisticated forms.

Such documentation might, for example, consist at first of the following: a list of holding companies and a list of fictitious or "front" companies, irrespective of the location of their head offices; a list of directors and addresses of head offices of such companies (they are generally concentrated at certain addresses); a card index of lawyers specializing in fraudulent operations; a compilation of information on flags of convenience.

To sum up, it seems clear that international administrative assistance in respect of assessment can offer real possibilities for tax supervision. However, advances in this area can be achieved only through an unequivocal declaration by all the major countries of their resolve to take effective action against all forms of tax fraud and tax evasion, both domestic and international.
A. DISTINCTION BETWEEN TAX PLANNING, TAX AVOIDANCE AND TAX EVASION

Tax planning

Tax planning is arranging one's affairs in such a manner as to minimize the tax burden by availing to the maximum extent possible all the tax benefits offered by the statute in the form of various tax exemptions and abatements, incentives and reliefs.

Tax laws in India provide a wide variety of incentives and reliefs for attracting foreign investment, technical know-how and technical personnel, for promoting the exportation of goods and technical know-how, for developing industrial and scientific research, for promoting social justice and for expanding the frontiers of knowledge. Provisions for exemption from tax on remuneration to foreign technicians and officials of any co-operative technical assistance programmes and for deduction of educational expenses of children outside India in the case of resident non-citizens, exemption from tax on interest on borrowings abroad from approved financial institutions or for purchase of raw material and machinery at approved rates of interest and low rate of tax on dividends, royalties and fees for technical services received by foreign enterprises from Indian concerns are all intended to encourage flow of foreign capital, technical know-how and technicians to India.

The law exempts from tax a non-resident's income from operations confined to the purchase of goods in India for exportation. In the case of an Indian enterprise, it exempts its income from dividends on shares allotted to it by a foreign enterprise for supply of patents and technical know-how and its income from royalties, commission and fees received from foreign enterprises for the use of its patents and technical know-how. Tax Credit Certificates and an export market development allowance are also granted to promote exports.

An effort is made to encourage industrial growth in general and the growth of certain industries in particular (i.e., priority industries), by allowing a development rebate at differential rates, amortization of expenses on acquisition of patent rights and copyrights and of certain preliminary expenses incurred before commencement of business, amortization of expenditure on prospecting for and development of certain minerals, a special deduction in respect of mining industries, a deduction of 6 per cent on capital employed from the profits of newly established industrial undertakings and hotels for a period of five years and an outright deduction of 8 per cent from taxable profits of certain priority industries; by relaxation of the provision for declaration of a statutory minimum dividend in the case of closely held industrial enterprises; and by concessional taxation of intercorporate dividends, royalties, commission and fees received by Indian enterprises from Indian concerns for provision of technical know-how and services. Investment activities are stimulated by exempting, up to certain limits, the income from dividends and interest on investments in approved securities and deposits for purposes of income tax, and investments for purposes of wealth tax, and by giving tax-credit certificates for subscriptions to eligible issues of capital. Savings are also encouraged by giving deductions for qualifying life-insurance premiums, premiums for securing retirement annuities to Indian citizens who are partners of professional firms and contributions to approved provident funds, and by exempting payments from such provident funds.

An attempt is made to promote industrial and scientific research by allowing the deduction of contributions for scientific research to approved institutions and of expenditure (including capital expenditure) on scientific research related to the business, by granting a development rebate of 25 per cent on the cost of assets acquired for such purpose and by exempting from tax the income of approved scientific research associations.

Through the tax law, an attempt is made to achieve social justice by allowing deductions from the total income of blind persons, for expenses on medical treatment of handicapped dependants; for employing displaced persons or repatriates in new industrial undertakings, and for donations to certain charitable institutions and funds; and by providing a rehabilitation allowance to industries ravaged by natural calamities or social upheavals, and concessional treatment to low-cost residential tenements.

A stimulus to knowledge and sports is provided by exempting from tax the incomes of universities and sporting associations; by permitting a deduction for tax purposes of 20 per cent of the profits from the printing and publishing of books, and by allowing, in certain cases, a spread-over of income from royalties or copyright fees for literary or artistic work. An effort is made to overcome barriers to knowledge by exempting salaries of visiting professors from outside and by providing concessional treatment to professors etc. who are resident in India, with respect to their foreign income from universities, educational institutions or approved associations; and by allowing a deduction of 25 per cent of the professional income brought into India from foreign sources by an author, playwright, artist, musician or actor resident in India.

In short, the law in India provides incentives for achieving a balanced national growth. This built-in mechanism of the taxing statute is based entirely on the assumption that every taxpayer would arrange his affairs as to derive maximum benefit provided by the statute, there by also promoting national development.

Tax avoidance

The law wants and encourages tax planning in its own interest, namely, the fulfilment of national policies. However, tax planning carried to extremes by exploiting the letter of the law in disregard of its spirit would degenerate into tax avoidance. The line of demarcation between tax planning and tax avoidance, though thin, is still definite. Manipulation of transactions by resorting to various stratagems and artifices, such as transferring assets while retaining control over capital and income; setting up subsidiaries or associate enterprises while retaining financial interests in the outcome of both, with a view to facilitating transactions at "arm's length" or "not at arm's length", as may be advantageous from the tax point of view; arranging transfer of losses of one concern for set-off against profits of another; and billing sales, purchases and services at higher or lower rates so as to divert the flow of profits from levels of higher taxation to the lower ones are devices that could be called planning, no doubt, but planning for tax avoidance.

In the preparation of this paper, the United Nations Secretariat had the assistance of R. D. Shah, Chairman, Central Board of Direct Taxes, New Delhi, India.
An explanation of what constitutes tax avoidance was clearly given by the statement of the Chief Justice in Commissioner of Income-tax v. Sakarlal Balabhai:

"... the avoidance of tax cannot include every case of reduction of tax liability of an assessee. The assessee may enter into a transaction which has the effect of diminishing his income and consequently reducing his tax liability; there would be no avoidance of tax in such a case. Take, for example, a case where the assessee makes a gift of shares to his son. Undoubtedly by reason of the gift, income from the shares would not accrue to the assessee, but would accrue to the son, and to that extent the income of the assessee would be diminished and his tax liability reduced. But that cannot be regarded as a case of tax avoidance even if the motive of the assessee in making the gift was to save tax on the income from the shares at the higher rate applicable to him. The same would be the position where the assessee sells the shares to a purchaser either by way of change of investment or as a dealer. Where the assessee divests himself of the source of income and, in consequence, his income is reduced, leading to diminution in tax liability, he cannot be charged with avoidance of tax liability. Tax avoidance postulates that the assessee is in receipt of amount which is really and in truth his income liable to tax but on which he avoids payment of tax by some artifice or device. Such artifice or device may apparently show the income as accruing to another person, at the same time making it available for use and enjoyment to the assessee. But there must be some device to enable the assessee to avoid payment of tax on what is really and in truth his income."\(^a\)

The same view was expressed in Australia, in Deputy Federal Commissioner of Taxation v. Purcell:

"The section (53 of the Australian Act), if construed literally, would extend to every transaction, whether voluntary or for value, which had the effect of reducing the income of any taxpayer; but, in my opinion, its provisions are intended to and do extend to cover cases in which the transaction in question, if recognized as valid, would enable the taxpayer to avoid payment of income-tax on what is really and in truth his income. It does not extend to the case of a bona fide disposition by virtue of which the right to receive income arising from a source which theretofore belonged to the taxpayer is transferred to and vested in some other person."\(^b\)

Both the taxpayer and the tax-collector look for the written word of the code for seeking or blocking escape from taxation. However distasteful the consequences of tax avoidance to the State, no other approach is possible, for the State would be in no position to exempt from tax a transaction which is taxable in law, however hard or unjust it may be to the taxpayer. This point is illustrated by the case of Gopal Saran v. Commissioner of Income-tax, where a man aged 47 years transferred all his assets, worth 240,000 rupees (Rs.), for life. The court held that the owner had exchanged a capital asset for a life annuity which was taxable as income in his hands. Had he merely placed this amount in deposit at interest, he would have received almost the same income without forgoing his capital. Revenue is not concerned with the unexpected consequences of a transaction or the intention underlying it, one way or the other.

Courts of different countries are almost one in their attitude to the question of tax avoidance. The Madras High Court stated in the case of Aruna Group of Estates v. State of Madras: "Avoidance of tax is not tax evasion and it carries no ignomy with it, for, it is sound law and, certainly, not bad morality, for anybody to so arrange his affairs with a view to reduce the brunt of tax to a minimum."\(^c\)

The Bombay High Court also took an identical view in the case of Provident Investment Co. Ltd.:

"A citizen is perfectly entitled to exercise his ingenuity so to arrange his affairs as may make it possible for him legally and lawfully not to pay tax and if his ingenuity succeeds, however reluctant the court may be to acknowledge the cleverness of the assessee, the court must give effect to the letter of the taxation law rather than stretch that letter against the assessee."\(^d\)

A similar view was expressed in Ayrshire Pullman Motor Services and Ritchie v. The Inland Revenue Commissioner:

"No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow—and quite rightly—to take every advantage which is open to it under the taxing statutes for the purpose of depriting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue."\(^e\)

In Inland Revenue Commissioner v. Duke of Westminster, the same view was expressed:

"I do not use the word device in any sinister sense; for it has to be recognized that the subject, whether poor and humble or wealthy and noble, has the legal right so to dispose of his capital and income as to attract upon himself the least amount of tax. The only function of a court of law is to determine the legal result of his disposition so far as they affect tax."\(^f\)

The Government frowns upon tax avoidance while it blesses tax planning. Tax avoidance may or may not be bad citizenship; but it certainly makes serious depredations on the planned economic efforts of the country and is therefore undesirable whether practised on an internal or an international plane. There is a constant battle of wits between the astute taxpayer and the Government, one seeking means of escape and the other attempting to block it. When areas of tax avoidance assume such large dimensions as to affect the revenues and resources of the country, the Government steps in and plugs all possible loop-holes in the statute. Fiscal legislation has inherent limitations and however well drafted and well defined the intentions, the amendments occasionally misfire. The astute taxpayer finds new loop-holes and takes advantage of them. Once again, the government machinery is activated.

**Tax evasion**

Just as tax planning may lead to tax avoidance, tax avoidance, in its turn, may lead to tax evasion. While tax avoidance effects tax savings by making use of the loop-holes in law, perhaps contrary to its spirit, tax evasion achieves it by breaking even the letter of the law. Quite often it is the fact that the evidence, though existing, is not available, that keeps the transactions in the realms of tax avoidance when, in reality, they would have meant tax evasion. Tax avoidance may not be illegal, but tax evasion certainly is.

It has been accepted by the community of nations that developing countries must be given assistance through various types of aids and loans. If this is so, then a natural corollary to this way of thinking, is that countries must recognize the paramount importance of the economic regulations introduced by developing countries to augment their internal and external resources. The community of nations could certainly at least co-operate in the matter of exchanging information concerning tax evasion in order to help in detecting economic offences.

International tax evasion is linked with the problem of the developing countries in raising internal and external resources. If a correct

\(^a\) *Income Tax Reports* (India), vol. LXIX (1968), p. 186.


\(^e\) *Tax Cases (United Kingdom)*, vol. XIV (1929), p. 754.

\(^f\) *Tax Cases (United Kingdom)* (1936), p. 1.
appraisal of the consequences of various types of international tax evasion were to be made, it would become apparent that it is in the mutual interest of the countries concerned to prevent such evasion. For example, the external resources of a developing country are reduced as a result of foreign exchange manipulations by some of its citizens.

B. TECHNIQUES OF TAX AVOIDANCE AND MEASURES TO DEALS WITH THEM

The scope for tax avoidance and the modus operandi for the purpose depend largely upon the field of manoeuvre available to the person, whether a resident or a non-resident, and upon whether his activities are confined to the territorial limits of the country or extend beyond it. The techniques of tax avoidance and the measures to combat them can be analysed according to whether the taxpayer is: (a) a resident operating within the country; (b) a non-resident operating within the country; (c) a resident operating outside the country, his dealings comprising transactions with non-residents; or (d) a non-resident operating outside the country in collaboration or co-operation with or through residents. The techniques may overlap, however because tax avoidance transcends all territorial limits.

Avoidance by residents

The techniques of tax avoidance by residents are well understood by now, and the measures deal with their actual manifestations in concrete form. The fundamental elements are few, but in combination they give rise to different forms. The law cannot eliminate the elements; it can only nullify the forms.

To escape taxation altogether or to be taxed at lower rates, one of the techniques is to arrange the trappings of an income transaction so as to transform it into a capital receipt in law. This technique can take a variety of forms and shapes, some of which have already been countered. For example, compensation for loss of managing agency and for loss of employment, though capital in nature, are currently taxable as income. Different types of distribution by enterprises or loans to substantial shareholders and directors by closely held concerns are treated as dividends for the purposes of taxation. To prevent such subterfuges in future, closely held concerns are required to declare a certain percentage of their income, by way of dividends, from year to year under threat of penal income tax. The law cannot, however, envisage all such transformations of income receipts into capital receipts, and it must deal with them as and when they come to light and assume significant proportions.

Benefits in kind can easily elude the tax net partially or wholly. Hospitality or gifts received in lieu of fees or other chargeable income, if so arranged as to appear unconnected, may escape taxation as income, though they are actually deliberate transformations of income. The law provides for countering all such attempts, whether adopted in favour of employees of by enterprises in favour of their directors, substantial shareholders and their relations, or by business-men or professionals, but it is only partially successful.

The incidence of tax can be reduced by transferring income or sources of income in such a manner as to derive the same or similar benefits of ownership, though indirectly. This technique is countered by legislation taxing the fruits of transfer in the hands of the transferor or settlor instead of the transferee or beneficiary. Formation of discretionary trusts, whereby a person could parcel out his income to escape the full incidence of income tax and wealth tax, has been discouraged by taxing them at sufficiently high rates. Likewise, the misuse of trust funds has been stemmed by denying exemption in the case of accumulation of income or investment of funds in a manner that indirectly provides the donor with the same advantages of ownership without making him bear the tax burden. Similarly, exemptions and deductions capable of providing scope for tax avoidance have been restricted or controlled by suitable legislation. Provisions have also been made to tax income from securities, in the hands of the original owner, on which tax is sought to be avoided or reduced by transactions designed for that purpose, such as "hand-washing".

A taxpayer indulges in tax evasion by resorting to such practices as suppression or understatement of production and sales, fictitious of inflated debits for purchases and expenses, and spurious partnerships or business conducted through nominees. Some of these are acts of commission and some of omission. Extensive and intensive inquiries may help in the detection of frauds of commission, but it is much more difficult to detect acts of omission. However, the counterpart of a transaction omitted by one need not necessarily be omitted by another in his books of account, and therein lies the hope of detection.

As in the case of tax avoidance, various refinements of the blatant act of tax evasion make detection difficult. Intermediaries—genuine or otherwise, existent or non-existent—are interposed between the two genuine ends of a transaction so as to confuse and confound the investigator. In the ultimate analysis, tax evasion, whether by acts of commission or of omission has the effect of secreting wealth outside books. In other words, it creates unaccounted money or, in popular parlance, "black" money.

Secreted wealth must be found out some day, in some way. It comes to the surface, no doubt, but under a heavy cloak of subtleties. It may appear camouflaged as borrowing through indigenous bills of exchange (i.e., hundi borrowings, a system of bills of exchange peculiar to India); or as assets acquired at prices paid in part out of accounted money and in part unaccounted. It may seek outlet in the acquisition of gold, bullion, jewellery and such other unproductive investments; or it may be frittered away in ostentatious living. It may be siphoned off to foreign countries through under-invoicing or over-invoicing of exports and imports, or through smuggling activities, and be put in foreign bank accounts or in investments abroad to escape the reach of local laws. There is no greater ill for the economic body of a country than "black" money. It corrodes moral values and builds up inflationary pressures.

For tackling tax evasion, the administration has been given powers of "spot survey" and of "search and seizure". Other deterrent measures are taxation of unexplained money, accumulated secretly over the years, in the year in which it manifests itself, i.e., when it comes to the surface and is observable by tax officials. Searches have led to detection of undercover activities on both national and international levels.

Measures to raise and recover taxes.

It is not enough that secreted incomes are brought to light and made subject to tax. Taxes have to be raised and realized. The aim of all tax administrations is to raise revenue. The law has therefore provided measures to prevent taxpayers from defeating the raising of tax demands or their recovery. The various provisions can be summed up as follows:

- (a) Deduction of tax at source and its payment;
- (b) Accelerated assessments in cases where it is apprehended that assets would be alienated or disposed of to avoid payment of tax liability;
- (c) Accelerated assessments of persons leaving India without intention of returning;
- (d) Prevention of transfer of assets while any proceedings are pending under the Income-tax Act with a view to defrauding revenue;
- (e) Production of clearance certificate in respect of discharge of tax liabilities before registration of sale documents of property worth more than Rs. 50,000;
- (f) Appropriation of assets seized under powers of search and seizure towards tax liabilities;
- (g) Personal liability of a liquidator of a concern for payment of taxes to the extent of the concern's liability as is notified to the liquidator within three months;
(i) Liability of directors of private limited companies for payment of tax dues of the company that is wound up, unless it is proved that non-recovery of taxes was not due to their gross neglect, misfeasance or breach of duty;

(ii) Recovery of partners' tax dues from the firm.

Apart from arming the tax administration with powers to raise and realize tax dues in time, the law has provided punitive measures as a deterrent to tax evasion. For concealment of income, a taxpayer is liable to a minimum penalty equal to the amount concealed and to a maximum of twice the amount.\(^1\) Wilful failure to file tax returns before the close of the assessment year is punishable by a fine or by rigorous imprisonment for a period of up to one year.\(^2\) False verification and abetment thereof in any of the declarations made under the Act and concealment of income are punishable by rigorous imprisonment for a period of up to two years.\(^3\) Failure to deduct tax from payments exigible to deduction, or failure to pay the amount deducted into the government treasury after deduction, is punishable by a fine and rigorous imprisonment which may extend to six months.\(^4\) Thus, prosecutions were launched in 85 cases for tax evasion during the financial years 1968/69 to 1970/71. During that period, 21 persons were convicted.\(^5\)

Adverse publicity can also act as a deterrent to tax evasion; and, with that end in view, the law authorizes publication of certain information concerning taxpayers and of the names of those penalized or convicted of tax offences. With a view to encouraging the inflow of information having a bearing on tax evasion, secrecy provisions have been relaxed and provision made for rewarding informers.

Avoidance by non-residents

The provisions of law outlined above relate largely to residents, but they also apply to non-residents to the extent relevant. A non-resident's activities in the country, however, are naturally circumscribed within narrow and definite bounds; hence, only those aspects of law which specially deal with them are discussed below.

Tax is required to be deducted and paid into the government treasury from interest (not being interest on securities) or any other sum (not being dividends) chargeable under the Act payable to a non-resident, unless the person responsible for deduction is himself liable to pay the tax as an agent of the non-resident. If the whole sum is not chargeable to tax, the proportion chargeable can be determined by the tax officials.

An agent of a non-resident or a person statutorily appointed as an agent is liable to be taxed in his representative capacity in respect of the profits of the non-resident deemed to accrue or arise in India. The Revenue Department, however, has the option whether to assess the non-resident directly or through his agent, actual or statutory. Tax can, however, be recovered from the assets of the non-resident which are currently in India or which may at any time come to India. As concerns salaries and other payments to non-residents where tax is deductible at source, if the tax is not deducted or paid as required by law, the payments themselves would be indefensible as deduction in the computation of the taxable income of the payer.

A person of foreign domicile is required to produce a tax-clearance certificate before leaving India. Failure to enforce this requirement renders the owner or charterer of a ship or aircraft personally liable for the tax dues of such person. While assessment is usually made on the income of the previous year, in the case of a non-resident apprised to leave the country permanently, assessment can be made in the same financial year.

\(^1\) India, Income-tax Act of, 1961, sec. 271 (1) (C).
\(^2\) Ibid., sec. 276C.
\(^3\) Ibid., sec. 277.
\(^4\) Ibid., sec. 276B.
\(^5\) India proceedings of the Lok Sabha (lower house of the Indian Parliament), 4 June 1971.

Uncovered area of tax avoidance

While a person can be appointed as an agent of a non-resident in certain circumstances; his liability as a representative assessee extends only to that portion of the income of the non-resident which is deemed to accrue or arise in India. With respect to other income, no person can be regarded as a representative assessee and assessed as such. Therefore, where income accrues to a non-resident in India, the question of "deeming" it as accruing does not arise, and the whole of it is liable to tax in his hands as such. If the assessments were proposed to be made on the agent, however, they will have to be made on him only with respect to that portion of the income which is reasonably attributable to the operations carried out in India; and the balance of the income attributable to the operations carried out abroad would not be taxable in the hands of the agent even though the entire income may be received in India by the agent. In other words, the assessment will have to be made on the non-resident directly, and if that measure, for some reason, becomes difficult, the agent in India would be liable only in respect of a part of the income.

Tax dues of a non-resident can be recovered from those assets of the non-resident which are or which may come within India, but no tax can be recovered by filing a suit in the country of residence of the non-resident.

Deals of residents with non-residents

Residents are liable to tax on the total income wherever accruing, whether in India or outside India. However, the relationship with persons abroad provides residents of India with vast avenues for tax avoidance and evasion, both of which are easy if the non-resident provides to the resident facilities for collusive transactions, as well as the supporting evidence. Tax liability is determined on the basis of the entries in accounts which are supported by vouchers whose verification is, however, not possible because of the territorial limitations of law.

Quantification of tax evasion in these areas of operation is almost impossible, but the extent can be gauged to some degree from the instances that have come to light in the course of the exercise of the powers of search and seizure by the various enforcement agencies. It would not be wrong to say that the problem is vast and serious.

Though the law provides remedies to deal with various techniques of tax evasion, in actual practice and for various reasons, such as lack of understanding of international business and want of economic data and of trained administrative set-up, the measures have little impact on tax avoidance. The fault can be said to be largely administrative and can be remedied with internal resources. The fact, however, is that these practices do cause untaxed profits to be transferred out of India. Once again, it would be difficult to quantify the tax impact of the schemes of tax avoidance on the revenues of India.

Where there is a close relationship between a resident and a non-resident, such as that which exists in the case of a holding company and its subsidiary, or a head office and its branch; or enterprises and individuals that are apparently independent, but that actually have common financial interests; or associate investors, there always exist facilities for arranging transactions of sales, purchases and services so as to yield little or no profit to the resident instead of the normal profits expected if the dealings were between two completely independent entities. In such cases, the law gives the power to a tax official to ignore the apparent results and to recompute the income of the resident on the basis of the data available, or by estimating a reasonable percentage of profit on the turnover, or by applying to the combined profits of the resident and the non-resident the ratio of the turnover in India to the world turnover, or by any other suitable method which would give reasonable results. The powers are wide but their use is sporadic due to...
lack of information concerning world market conditions and administrative insufficiencies.

Granting that these difficulties are surmounted by developing a well-equipped and well-trained tax machinery, there is still the problem of tax recovery. Efficient utilization of powers would enable the tax administration to determine the taxable income of the resident who has transferred profits out of the country through the use of a non-resident. The obvious effect of such transactions is to deplete the assets and resources of the resident in India. If the assessments were to be made on the real income (as against the book results which have been artificially reduced), however, a question arises concerning the way in which the resident would find the resources from which to be able to meet the tax liability based on his real income. This is the crux of the problem. No liability is attached to a non-resident, while the resident has no means (this being deliberately so arranged) to pay his tax liabilities. In such cases, international conventions have to be established or suitable laws made at international level, whereby tax recovery can be made from the non-resident's assets in his home country to the extent of the advantage derived by him as a result of the scheme of manipulation. This is in the interest of all countries, whether developing or developed, because profits, like liquids, would flow from higher levels of taxation to lower ones. It is not a question of country X or country Y, but what their levels of taxation are.

Where a non-resident functions through a branch in India and the branch maintains complete accounts and is taxed on the basis of these accounts, the scope for reducing the taxable income by means of exaggerated claims for expenses incurred abroad is almost limitless. Such a claim is usually based on the total expenditure incurred by the head office and is allocated to the branch in the ratio of the branch turnover to the world turnover. The evidence for the claim is usually the head-office certificate or, at best, an auditor's certificate. The auditor's certificate is accepted by the tax officials with the respect it deserves, but experience has shown that the procedure opens up many avenues of tax avoidance. Interbranch/head-office sales and purchases are open to overstatement and understatement, depending upon the direction desired for the flow of profits. Expenses strictly pertaining to the head office may be passed on to the branch; royalties and interest may be charged to the branch directly (in which case they would be inadmissible, if explicitly shown), or indirectly by means of associate operations. In other words, there is a lot of elasticity in the interbranch/head-office arrangements so that only such results as are desired by the management are produced. Tax officials undoubtedly have a right and a duty to carry out necessary adjustments for determining the taxable income, but the actual performance of this duty has many limitations arising out of the absence of precise information as to the course of dealings, want of economic data and commercial intelligence, and administrative insufficiencies.

The following analysis of head-office expenses claimed by a branch in the determination of its taxable income is revealing.

### Table 1. Head-office expenses claimed less than branch profits

(Millions of rupees)

<table>
<thead>
<tr>
<th>Branch of a non-resident enterprise operating in India</th>
<th>Year of assessment</th>
<th>Amount paid to head office as expenses incurred on behalf of branch</th>
<th>Profit as per profits-and-loss account before deduction of expenses in column 3</th>
<th>Proportion of column 3 to column 4 (percentage)</th>
</tr>
</thead>
<tbody>
<tr>
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<td>5</td>
<td>5.00</td>
<td>6.40</td>
<td>78</td>
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</table>

* By way of technical assistance fee.
In tables 1 and 2, statistics are given for different years for the same enterprise. Wide fluctuations in the percentages of allocable head-office expenses for different years for the same enterprise are significant pointers to probable manipulations.

**Basis of allocation of head-office expenses**

The allocation of head-office expenses to a branch office is a measure of the effort and the services rendered by the head-office staff to the working of the branch. One should have no difference of opinion as to the principle of allocation as such, but what is objectionable is the method of determination of such expenses. Allocation on the basis of turnover suffers from a serious drawback. For instance, a branch that is being newly opened in one country requires for its setting-up a large part of the head-office administrative and executive manpower, as compared with a branch in another country which is already well established. However, on the basis of the allocation according to the turnover, the new branch will have nil or a small turnover; therefore, it will have very little or no expenses allocable to it, while the well-established branch with a large turnover will have a higher amount allocable to it. In other words, in this mode of apportionment, what happens is that the burden of one branch is passed on to another. This means that a non-resident enterprise can set up new branches in different parts of the world or in its own country at the expense of other branches flourishing elsewhere.

This situation should not be allowed to continue, and a reasonable understanding has to be arrived at the international level to ensure all-round acceptance of a common principle and its uniform application, so that the expenses of one branch are not passed on to another. Thus, there is need for a precise classification of all such head-office expenses as should be considered allocable to branches. Classification should be detailed and terminology uniform so that there is no confusion in the minds of tax officials of the different countries as to the exact import of certain items of expenditure. Secondly, turnover as the basis of allocation is unsatisfactory as a measure of the effort on the part of the head office. Turnover itself is a vague term and is capable of generating unintended or intended distortions. In one case, it may be sales; while in another, it may be fees or commissions. Proportions of the two items that ultimately go to the making of profit or loss are so vastly different that turnover cannot be a satisfactory standard. Perhaps, one of the methods suitable for quantification of the head-office effort may be to adopt the man-hour basis. While it is true that in a vast organization it is not easy to measure time utilization at different levels and for different branches, it would not be difficult to evolve a reasonable method.

The examples given below illustrate how a non-resident head office and its branch office in India may arrange their accounts and accounting procedure to minimize tax incidence in India:

(a) In the case of a publisher and seller of books, the world profit-and-loss account and balance-sheet, together with the profit-and-loss account and the balance-sheet for the Indian branches, were produced for tax purposes. A claim was also made for deduction of proportionate office expenses attributable to Indian business from the profit shown as per profit-and-loss account for the Indian branches. This procedure was all right, in principle, so far as it went. However, glaring disparities were noticed between the gross profit percentage according to the world profit-and-loss account and that according to the Indian profit-and-loss account. A careful scrutiny showed that the non-resident was adopting a peculiar method of accounting according to which all publications, wherever published, were treated as if published in the home country and sold to branches. The prices charged to branches were not actual, but were arrived at by deducting at a flat rate of 25 per cent from the market price. This was an *ad hoc* method of accounting and did not represent the true state of affairs. The enterprise ultimately agreed to a suitable upward revision of its taxable income as shown by the Indian profit-and-loss account. As this method had been adopted from year to year, however, the enterprise got away with tax benefits for some of those years which were beyond the reach of the law for purposes of back-duty assessments;

(b) In another case of a branch operating in India with its head office outside India, a claim was made and allowed from year to year for deduction of proportionate head-office expenses from the profits of the branch for tax purposes. In addition, the non-resident head office used to charge the branch 3-5 per cent by way of handling charges on purchases made for supply to the branch. The price otherwise charged to the branch was cost plus insurance plus freight.

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<td>-40.0</td>
<td>More than 100</td>
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</table>
etc. A careful scrutiny disclosed that the head office was accounting for handling charges as its income so that the expenses incurred by it on this behalf should have been debited against this income. Instead, they were debited to the expenditure account, which, in turn, was the basis for allocation of expenses to the branch. In other words, the non-resident was claiming a double deduction. It was further found that the method of keeping account was such that it made no distinction between expenses incurred by the enterprise on trading in the home country and the expenses incurred and allocable to the branches. This again meant an unjustified charge on the profits of the branch;

(c) A manufacturing enterprise in India had a contract with a non-resident concern, which consisted of two parts: one was a lump-sum contract for the erection and satisfactory performance of the plant; the other was for field services. Profit of the field-service contract was determined annually on the basis of a receipt and expenditure statement extracted from the books of accounts maintained for the whole contract. The profit of the field-service contract was taxed annually on this basis; but the result of the lump-sum contract was to be determined on the completion of the contract and was to be allocated annually on the basis of work done. Thus, two separate procedures of accounting were adopted for tax purposes. The result was a confusion to the advantage of the non-resident manufacturer in so far as the same expenses were claimed and allowed twice over.

These cases highlight the need for a uniform system of presentation of accounts in order to minimize or eliminate chances of understatement or mis-statement of profits before the tax authorities. It may even be worth while to evolve a suitable form of presentation in a code or convention that may be established by inter-State efforts to deal with tax avoidance and evasion.

Non-residents acting in collusion with residents

The law provides that interest payable by an industrial undertaking in India on any monies borrowed or debt incurred by it in a foreign country in respect of purchases outside India of raw material or capital plant and machinery is exempt from tax to the extent of the amount of interest calculated at the Government-approved rate, which is 6 per cent per annum. Where the borrowing was at 9 per cent, the agreement was revised to reduce the rate of interest from 9 per cent to 6 per cent so that there would not be any liability to tax on the non-resident. The arrangement failed to achieve its purpose, because the condition that the borrowing should have been for the purchase of raw materials or capital plant and machinery outside India was not satisfied. The non-resident thereafter produced evidence to show that it had borrowed from another enterprise in its home country at a rate of interest which was higher than the lending rate to the Indian resident; and, therefore, no profit was accruing to it in India. In the light of the successive arrangements and transactions contrary to ordinary commercial practice, the agreements appeared to be collusive, but the territorial limitations of the law prevented their investigation.

The Finance Act of 1961 provided that in cases where an agreement was entered into with an Indian concern or on or after 1 April 1961, and was approved by the Government, non-resident company would be given a super-tax rebate of 25 per cent on its income from royalty. A non-resident enterprise that had entered into an agreement with a resident in 1955 for a period of 10 years suddenly revised its terms in 1963, just two years before the time the agreement was due to expire. On the basis of the revised agreement, the non-resident claimed super-tax rebate as provided by the Finance Act of 1961. It was, in a sense, the same agreement; but it was made to appear to be a new one with some modifications of an inconsequential nature.

Similarly, the Finance Act of 1964 made a provision for super-tax rebate of 30 per cent on the income of a concern consisting of fees

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*a* India, Income-tax Act of 1961, sec. 10 (15) (iv) (c).
There would be no question of purchase of any plant and machinery without the requisite technical assistance from the seller for its setting-up and performance. The two are inextricably interwoven and cannot exist independently of each other. Even so, such contracts are given a legal form according to which the title to the machinery passes outside India and the purchase price is also paid outside India so that the profit on sale of machinery does not accrue in India. Profit in respect of constructional services, however, would accrue in India and would be taxable. The price components of the total sale transaction are so arranged that most of the profits accrue outside India, the sale price of machinery having been inflated to include the profit element of the construction contract. So far as the buyer or the seller is concerned, it makes no difference to him, and the only loser would be the revenue.

In such cases, the only way out for the tax administration would be to consider the contract as a whole, determine the profit and then allocate it between the sales and the services, or in the alternative, take the prices of machinery at market rate, as it would be independent of constructional services and treat the difference as the profit on constructional activity. However, it is difficult to get reliable information regarding the correct market price because in big industrial projects no two plants are alike. The best course, therefore, is to take the contract as a whole and apportion the profits.

**Undercover activities**

Manipulations are resorted to by both residents and non-residents through their associates operating in the other country in order to reduce their taxable income in India and also for the purpose of secreting foreign exchange abroad. Such transactions ordinarily cannot be detected through scrutiny of books of account. The only way that they could be brought to light would be through searches. Complete investigation is possible, however, only if the two countries co-operate in a common endeavour to detect the tax fraud because such manipulations are necessarily made at both the ends unless, of course, the tax rates in the other country are so low as to make manipulations not worth while. As a rule, there would be a scheme of complicated arrangements to shift profits from one country to another. So long as the arrangements are legal, objections, if any, would be futile; but there is every possibility of some aspect of the transaction being impugned in both the countries. It would therefore be useful for the countries to conduct concerted investigation in co-operation with each other.

**Under-invoicing and over-invoicing of exports and imports**

Under-invoicing of exports may be resorted to in various forms for purposes of tax evasion. For example, the export may be made at the market price so that there is no suspicion attached to the transaction, but claims would be made by the non-resident buyer for shortages and substandard quality of goods. Such claims can be unreal and yet supported by a mass of motivated correspondence, but without the backing of authentic documents. Such engineered claims help the resident exporter to transfer his funds to foreign countries without the tax administration having any clue as to whether the disbursement was in discharge of a genuine claim or was only a ruse to transfer foreign exchange through the intermediary of the non-resident. Under-invoicing of exports is a "racket" of large dimensions affecting both the internal revenues and the external resources of the country.

Under the Export Promotion Scheme, the Government of India used to give incentive import licences. Under those licences, the licence holder had the freedom to import goods of his choice; and, evidently, his choice fell on those items which were scarce and fetched high prices in the local market. The incentive licences were openly sold at substantial premiums. To obtain such licences, some exporters over-invoiced their exports to dummy buyers who were put up for the purpose. Obviously, these goods would not fetch their full export value in foreign countries because they were over-invoiced. The dummy, therefore, met the deficiency on realization of the sale proceeds by purchase of foreign exchange at a premium in order to be able to remit the full amount. The Indian exporter would be able to make substantially large profits which would more than compensate him for his loss on unauthorized buying of foreign exchange either by importing and selling the goods covered by the incentive licences or by selling outright the import entitlements. In that case also, he would have to manipulate his accounts to reduce his taxable profits, which would obviously be large.

From documents seized in the course of searches, it was discovered that an enterprise resident in India was over-invoicing its imports by as much as 40 per cent. The transactions were arranged somewhat on the following lines. Pro forma invoices were sent by the non-resident to the resident importer. The invoices would give particulars as to the quality, quantity, rate, value etc. in separate columns; but the original invoices had, in addition, certain entries made in pencil. A scrutiny of these invoices showed a uniform pattern in the making of these pencil entries. A careful analysis of the entries showed that the prices at which goods were invoiced were consistently inflated at 40 per cent of the real cost. From the documents available, the excess (of 40 per cent) was traced to a foreign bank account of the managing director of the Indian concern.

Over-invoicing increases the cost of raw materials, while enhancing depreciation allowance and development rebate in the case of plant and machinery; and it thereby reduces profits, taxable income and taxes. It also helps to transfer funds abroad and leads to a draining-off of the valuable foreign exchange resources of the country.

Transactions occasionally are arranged with the sole object of remitting surreptitiously foreign exchange in order to make it available for various activities, such as unauthorized transactions in foreign exchange or smuggling. For this purpose, the goods selected for import are usually trash and of low value and for which the customs duty is also low. Such goods would be invoiced at prices substantially higher than that for which they are actually purchased in foreign countries. The Indian resident would open a letter of credit in favour of a dummy or his agent and would send remittances to him against the importation of such (trash) goods. The difference in the value received from India and the price paid for purchase of these goods would represent foreign exchange secreted out of India. In other words, foreign exchange is artificially taken from India. The sale of these goods would obviously result in a book loss because the import price has been heavily inflated. Incidentally, such a loss might be available to the resident for a set-off against his other profits, if any, which would mean that he would further utilize the transaction for reducing his taxable income in India.

In the usual run of business, imports are over-invoiced; but a dealer sometimes finds it worth while to get his imports under-invoiced. This technique is used when a dealer wishes to import a larger quantity of goods for the same value of licence, or, for example, as concern goods that are scarce and have a large market value in relation to their c.i.f. value. The resident importer would have to meet the difference between the purchase price of the full quantity of goods in a foreign country and the invoice price that he is allowed to remit under the import licence, which he does by purchasing his foreign exchange requirements in an unauthorized manner. This type of transaction is to the advantage of both the foreign exporter and the Indian importer. The former is able to increase his sales, while the latter hopes to gain on customs duty, the invoice price being low, in addition to obtaining a larger quantity of goods than licensed. For the Indian importer, however, this is only the beginning of a chain of manipulations that he would be required to make if he were to retain the illegal benefits accruing to him from the transaction. Low price of imports with high market value would mean larger taxable profits and larger taxes. This fact, combined with the fact of purchase of foreign exchange at a premium, would necessarily result in an over-all loss to the resident importer unless he were to manipulate his accounts so as not to disclose his real profits to the tax department. Manipulations in this class of cases are usually
complicated and defy, delay and sometimes defeat investigations. Granting that investigations succeed, recovery of taxes is always a problem.

Problems of investigation without active international co-operation

In the course of a search, some documents were seized from an Indian national, and they showed that he had a long-standing interest in company A in a foreign country, whose managing agent was his close associate. Secret funds generated in various ways, as described above, were credited in the account of that concern and were utilized for the purchase of foreign shares and securities. Company A had a subsidiary, B, in another country. Both arrangements were set up to accommodate foreign exchange earned through under-invoicing and over-invoicing, and through secret commissions retained abroad on purchase of plant, machinery and raw material. Any full-scale investigation would require evidence from the different countries where there were links with reference to deposits, remittances, shareholding etc. In order to get at the necessary evidence, letters rogatory were sent to the district court of the foreign country. The court held, however, that the Indian income-tax officer did not constitute a tribunal; and, therefore, the court was not competent to call upon the witness to appear and give evidence.

In another case, an Indian national was receiving substantial commissions from a concern in a foreign country, which were deposited in his foreign account through which investments were made abroad. The foreign enterprise having links with India responded to the inquiries made by the tax administration and produced evidence of payment to the Indian national, but the liability could not be fixed upon him because he claimed almost equivalent expenses against these receipts. The administration could not pursue its inquiries to the logical conclusion for want of cooperation. It is true that an assessment could have been made on the basis of evidence, the taxpayer being required to establish his case. However, the question of recovery of the tax liability would have remained a problem because the assets of the resident were outside India and beyond the reach of Indian laws. No prosecution could also be possible because the offenses in that case would have shifted to the department which would be in no position to discharge it for want of conclusive evidence.

C. INTERNATIONAL INCOME-TAX EVASION OR AVOIDANCE AND BILATERAL AGREEMENTS

India has entered into bilateral agreements with several countries, some of which are comprehensive in the sense that they cover all types of incomes; while others, such as those with Lebanon and Switzerland, are limited to the taxation of income derived from specified activities, e.g., operating aircraft. The earliest of such agreements is the one with Pakistan which, having been made in the context of the partition of a single country into two, falls in a class by itself and details, in a schedule annexed thereto, the percentages of various types of income that will be subjected to tax in the two countries. The agreement with Ceylon also includes a similar schedule. The other agreements, more or less, broadly follow a general pattern and adopt certain internationally accepted norms of allocation of tax jurisdiction, notable among which is the principle that industrial and commercial profits of an enterprise of one country should be charged to tax in the other country, only if that enterprise carries on the trade or business through a permanent establishment situated therein. The definition of the term "permanent establishment" is also based on certain generally accepted principles. A fairly precise definition has no doubt been attempted, but there is always scope for an ingenious person to arrange his affairs in such a way that he is not caught by the letter of the law.

Under the Income-tax Act of 1961 (section 91), a resident of India, who derives income from a foreign country with which India does not have a double-taxation agreement, is granted unilateral relief from double taxation of such income. The Indian tax chargeable on the foreign income is reduced by the amount of foreign tax. If the foreign tax is equal to, or exceeds, the Indian tax on the foreign income, the Indian tax in respect of such income is reduced to "nil".

The basic principles followed by India in its agreement for the avoidance of double taxation of income with other countries are as follows:

(a) The income shall be taxed primarily in the country of its source, i.e., by the country in which it actually accrues or arises. Where under the normal tax laws of the other country such income is taxable, the double taxation should be relieved by that other country;

(b) Where, in respect of any income, tax is spared by India under its special provisions for the purpose of encouraging foreign investment or promoting new industrial enterprises, the other country should give credit for such tax forgone by India.

To achieve these objectives, India has in the agreements followed either of the following two methods, or a combination of both:

(1) Straight segregation method, i.e., the source country alone should tax the income and the other country should exempt such income from taxation;

(2) Credit method, i.e., where the income is subjected to tax in both the countries, the country of residence of the taxpayer should give relief for the tax actually charged, including the tax spared or waived by the other country under its special provisions, the credit being limited to the tax leviable by it on the doubly assessed income.

Tax treaties

Tax treaties can be of great help in combating tax evasion at the international level. They can also be useful in facilitating normal assessment and collection of taxes relating to international income. Some of the bilateral treaties of other countries include clauses for exchange of information required to ensure normal assessment and collection of taxes and also for the purpose of enforcing statutory provisions concerning the prevention and punishment of tax evasion. The agreements can be useful for obtaining from banks abroad information which will have a bearing on investigation of fraud in individual cases. Banks are the natural channels of international monetary transactions, and evasion at the international level cannot be tackled unless there is an arrangement for obtaining information from foreign banks. Recently, the Federal Tribunal of the highest court of Switzerland authorized Swiss Federal authorities to give information to the Internal Revenue Service in the United States of America about an American citizen's account with a Swiss bank. The Federal Tribunal ruled that Switzerland was obliged, under article XVI of its double-taxation agreement with the United States of America to give competent United States authorities information to prevent or detect crimes of fraud. They also said that the Swiss Banking Agency (given status in the Swiss Code since 1934) protected a bank's customer from routine inquiries about possible tax evasion, but not if there were grounds for suspecting more serious offences of tax fraud.

Concept of permanent establishment

While tax treaties can be useful instruments for ensuring avoidance of double taxation and for exchange of information for dealing with tax fraud, they sometimes give scope for deliberate avoidance of tax. The fact that the tax laws of different countries present widely varying features in relation to liability to tax, rates of tax and scope and extent of exemptions often facilitates such avoidance. For

* Austria, Ceylon, Denmark, Federal Republic of Germany, Finland, France, Greece, Japan, Lebanon, Norway, Pakistan, Romania, Sweden, Switzerland, United Arab Republic.

* France-Canada, Switzerland-United States of America, United Kingdom-Japan.
instance, most of the tax treaties provide that industrial and commercial profits of an enterprise of one country should be taxed in the other country only if that enterprise carries on such activity through a "permanent establishment" therein. This concept of "permanent establishment" permits enterprises from developed countries to realize substantial profits from sources in the developing countries without paying tax to the latter by so arranging their affairs that the activity is carried on without a "permanent establishment". Broadening the definition of "permanent establishment" could be helpful in preventing such avoidance.

In its bilateral agreements for avoidance of double taxation, India has accepted the concept of permanent establishment, as well as the aforesaid principle of allocation of tax jurisdiction in respect of industrial and commercial profits. The definition of permanent establishment in the bilateral treaties concluded by India is more or less on the lines of the Draft Double Taxation Convention of the Organisation for Economic Co-operation and Development. This has been taken advantage of by non-resident taxpayers to avoid proper taxation in the source country. As it happens, the rates of taxation in most of the developing countries are higher than the rates in developed countries. Some of the prominent areas in which tax avoidance has been commonly resorted to are discussed below.

"Permanent establishment" means a fixed place of business, which has been defined to include carrying on of a "construction, installation, or assembly project or the like". There is no time-limit for the existence of such construction etc., in the tax agreements of India, except in those with Austria, France and the United Arab Republic. The time-limits in the agreements with these countries are one month, three months, and 90 days, respectively. However, if the expenses incurred on the activity of installation etc. are more than 10 per cent of the total sale price of the order, the income becomes taxable notwithstanding that the period of installation etc. does not exceed the specified time-limit. This provision is usually circumvented by the non-resident manufacturers and suppliers of plant and machinery by arranging for the installation etc. through the Indian residents concerned, to whom services of the technical personnel are lent on a per diem basis. The non-resident concern thus avoids payment of tax in the source country in respect of its income from the sale of plant and machinery, because it does not have a permanent establishment in India within the meaning of its definition in the tax agreements.

Agents

Similarly, the definition of permanent establishment covers the case of a dependent agent who has the authority to conclude contracts on behalf of the non-resident principal. It has been noticed that while the non-resident principal appoints agents for certain territories, to whom commission is payable in respect of all transactions emanating from their respective territories, care is taken not to delegate authority to the resident agent to conclude contracts on behalf of the principal. Thus, the non-resident has the facility of a regular liaison office in the developing country, which in effect looks after the interests of the non-resident principal in that country in return for a commission at a specified percentage. The non-resident, however, pays no tax on the profits on sales effected in that territory because this liaison office does not qualify as a permanent establishment. This situation leaves enough scope for tax avoidance.

Brokers and intermediaries

A broker of genuinely independent status who acts merely as an intermediary between an enterprise in one territory and a prospective customer in the other territory, does not constitute a permanent establishment. This is what it should be and has been recognized in agreements of India. Though such a broker does not otherwise satisfy the test laid down for holding him as constituting a permanent establishment, it can happen that he acts wholly or almost wholly for a particular non-resident enterprise and its affiliates. In these circumstances, the broker can no longer be said to be genuinely independent, inasmuch as he devotes himself exclusively or almost exclusively to the advantage of a particular non-resident; the Ad hoc Group of Experts did not favour the suggestion of treating such an agent as constituting a permanent establishment; but it did agree that where the activities of an agent were devoted wholly or almost wholly on behalf of an enterprise, he would not be considered an agent of independent status.

Lending services

Another important method of seeking tax avoidance on a substantial scale is the furnishing of services of employees in return for fees calculated on a per diem basis. A view is often canvassed that foreign enterprises lending the services of their employees are not covered by the treaty provisions governing the allocation of tax jurisdiction in respect of remuneration for professional services, which terms are confined to services being rendered by individuals. Whether the profit from the furnishing of such services can be termed "industrial and commercial profits" is itself a debatable question. In any event, the rendering of services through employees whose services are placed by a non-resident enterprise at the disposal of a resident does not result in taxation of the profit embedded in the fee, in the absence of a permanent establishment of the non-resident concern in the other country.

Need for broader Tax Treaties

The current law authorizes the Government of India to enter into agreements with other countries only for avoidance of double taxation. There is no provision to enable the Government to enter into wider tax treaties providing, in addition, for exchange of information and other facilities for combating tax evasion. The bilateral agreements that India has so far entered into with other countries are mere double-taxation avoidance agreements. There is urgent need for broadening them into tax treaties, which, apart from providing for avoidance of double taxation, would also be effective instruments in dealing with international evasion of tax.

Adequate arrangements have also to be made for the exchange of information relating to tax evasion having international ramifications. Current provisions in the bilateral agreements for exchange of information are very restrictive in nature and are confined to such information as is necessary for carrying out the provisions of the double-taxation avoidance agreement.

Information exchange

Intelligence and information alone can help in dealing with problems of tax evasion on both the national and the international planes. At the national level, the problem is largely administrative. There is need to set up an effective machinery, assisted by modern technological aids, such as computers, for collection, dissemination and utilization of data. Local laws can provide for furnishing the desired information within the state's territorial jurisdiction. They can also provide for establishing surveillance and enforcement agencies to detect and deal with tax frauds arising out of "racketeering", smuggling etc. Success or failure depends upon the effectiveness of the machinery. Real difficulties arise, however, with respect to gathering information and intelligence from outside the home country. It is in the interest of all concerned that an understanding is reached at the international level for the supply of information necessary to establish tax evasion. The nature and extent of information and the procedure for obtaining or furnishing it can be laid down by agreement with the accepted common objective of fighting tax evasion. Furnishing of information by foreign countries could even be made conditional upon the home country setting up a suitable administrative machinery for its utilization.

\[p\] Agreement between India and the Federal Republic of Germany, for avoidance of double taxation (1959), art. II.

\[a\] See, for example, agreements of India with Federal Republic of Germany, art. XVII; Japan, art. XII; and Sweden, art. XVIII.
Requisitioning of information under Indian law

The Indian income-tax law provides for deduction of tax at source from payment of salaries, interest on securities, dividends and other interest at appropriate or prescribed rates of tax. It is immaterial whether the payee is a resident or a non-resident. In respect of tax deductions, the payer is required by law to furnish information to the tax authorities giving the names and addresses of the payees, amounts paid, dates of payment and amount of tax deducted. These statements are required to be submitted in the prescribed form and by the prescribed date. In addition to these information returns, individual taxpayers are required to furnish, along with their returns of income, information as to the names and addresses of the persons to whom items of income, such as rent, interest, commission, royalty, brokerage or annuities, have been paid in a year in excess of the prescribed amount (currently Rs. 400), as well as other details about the amounts and dates of payment.

The information required is not restricted to items of income only; individual taxpayers are also required to furnish information concerning their partners (in case of firms), beneficiaries (in case of trusts), and donees (in case of gifts). Where the taxpayer is a stock or commodity exchange, the required information may relate not only to "difference" of over Rs. 2,000 (which constitutes income) paid by them, but to the proceeds of sale of shares or commodity in excess of Rs. 10,000 realized and paid through them. The law also permits extraction of information from the registers of share/ debenture holders and mortgagees.

To enable tax authorities to discharge their functions under the Indian Income-tax Act, the powers of a court of law in respect of the following matters are vested in them: (a) discovery and inspection; (b) enforcing attendance of witnesses and examining them on oath; (c) compelling production of books of accounts and documents; and (d) issuing commission. The law also enables requisitioning of such information from banking establishment as may be necessary for any of the proceedings under the Income-tax Act.

It will thus be seen that the law has provided massive machinery for an automatic inflow of information concerning various items of income and receipts, including capital receipts, which may be embedded elements of income, and for obtaining from individual taxpayers and others, including banking establishments, information necessary for the proper discharge of the functions under the law. Powers of search and seizure and of on-the-spot survey enable effective functioning of intelligence units, which are so necessary for detecting under-hand activities and tackling tax frauds. In order to enforce compliance with the requirements in the matter of furnishing of information as detailed above, the law provides for prosecution under which the maximum fine imposable is Rs. 10 per day of default. For failure to comply with the summons, the income-tax officer is himself authorized to impose a fine of up to Rs. 500. Disobeying the orders issued in exercise of the powers of search, or prohibiting removal of books and assets, exposes the offender to rigorous imprisonment extending up to two years and also makes him liable to a fine.

However, the machinery for collection of information and intelligence is available only in the case of those who are assesses as defined in the Act. It can be set in motion only if there is some proceeding pending under the Act in respect of the assessee, whether he is resident or non-resident. Therefore, in those cases where there are no pending proceedings, no information can be obtained by tax authorities. Thus, no information can be obtained in the case of foreigners who are not assesses.

Whatever information is available on tax records can be disclosed to the authorities specified in the Act to the extent necessary to enable them to discharge their functions. Information can also be disclosed to any other person on an application being made to the Commissioner of Income-tax, provided the Commissioner is satisfied that the supply of information is in the public interest.

Suggested broadening of existing law

The first requirement that would enable India to obtain information from other countries would be to enlarge suitably the scope of section 90 of the Income-tax Act and thereafter to revise its agreement with other countries in the matter of exchange of information with a view to bringing them in line with the provisions contained in the tax treaties between the United States of America and Japan, Switzerland and the United Kingdom. Provision for exchange of information similar to those existing between developed countries are all the more necessary for developing countries because the flight of capital, profits and foreign exchange is often in the direction of the developed countries. If suitable changes in the agreements are not brought about, there is no other machinery available whereby such information can be obtained.

This situation highlights the need for enlarging the provisions of the bilateral tax treaties so as to include a clause for exchange of information for the prevention of fraud or tax avoidance. As mentioned earlier, tax authorities in India obtain voluminous information concerning the incomes earned by non-residents in India (as also by residents of India). The treaty provisions should provide for automatic exchange of information somewhat of the lines of an earlier convention between France and the United States of America. This exchange would enable each of the Contracting States to receive information as to the income earned by its citizens in the other State—an important step in tackling tax avoidance or evasion.

With the wide variety of direct taxes that are leviable in India and elsewhere, there is need to ensure that agreements with foreign countries shall cover all such taxes and shall not be restricted to income tax only. Exchange of general information relating to tax laws and fiscal policies would also help in understanding better the problems involved in taxing international income, and exchange of information concerning general market conditions etc., would be useful in tackling cases of international tax evasion. In fact, investigation of many tax fraud cases where under-invoicing or over-invoicing is alleged is greatly hampered by the absence of authoritative market information relating to the price patterns prevailing in other countries.


** For example, in a case of suspected tax fraud, the provisions of the United States Code, Vol. 28, sec. 1782 (a), were invoked, and letters rogatory were issued to the district court in the United States of America to obtain certain information required in order to establish the tax fraud. The Court of Appeal examined the question whether the income-tax officer functioning under the Indian Income-tax Act of 1961 was a foreign tribunal within the meaning of the expression in the said section. The Court held that the income-tax officer remained a tax-collector and not an adjudicator and did not possess the complete objectivity associated with a tribunal, and that since the income-tax officer had the sole responsibility for making the Government's argument, as well as for evaluating it, he would not come within the concept of a tribunal which an American legislature would accept. The result of this ruling is that a tax official in India is not in a position to obtain information about tax fraud cases from the United States of America.

*** The convention between France and the United States as signed in Paris on 25 July 1939, provided, in part, as follows:

"If competent authorities of the United States of America will transmit to the competent authorities of France, as regards any person, corporation or other entity (other than a citizen corporation or other entity of the United States of America) having an address in France and deriving from sources within the United States of America rents, dividends, interest, royalties, income from trusts, wages, salaries, pensions, annuities or other fixed or determinable periodical income, the name and address of such person, corporation or other entity as well as the amount of such income."

1. India, Income-tax Act of 1961, chap. XVIII-B.
3. Ibid., sec. 134.
4. Ibid., sec. 131.
5. Ibid., secs. 132 and 133 A.
6. Ibid., sec. 276.
7. Ibid., sec. 131 (2).
8. Ibid., sec. 275 A.
9. Ibid., sec. 134.
10. Ibid., sec. 276.
11. Ibid., sec. 132.
12. Ibid., sec. 131.
13. Ibid., sec. 134.
14. Ibid., sec. 275 A.
Another aspect of taxation where bilateral treaties could provide for useful co-operation is in relation to assessment and collection of taxes. No effective arrangement currently exists for making even a normal assessment on a non-resident unless the taxpayer himself co-operates. There is no arrangement for recovering tax dues from a non-resident except from assets in India. Tax treaties could operate to facilitate such proceedings. They could also provide for machinery for collection of taxes on the lines of the provision with respect to assistance in collection contained in article 27 the tax treaty between France and the United States of America (see appendix to this annex).

A treaty provision requiring the exchange of fiscal information is of great importance to developing countries. Authoritative information relating to business operations abroad could be of help in assessing correctly the income of foreign enterprises arising in the taxing State, as well as the income of its own nationals arising abroad. Another significant contribution of such a treaty would be the assistance it could render in the matter of collection of taxes out of assets situated abroad, particularly, as such assets are out of the reach of the municipal laws of the taxing State. Apart from such concrete benefits, the mere existence of such provisions would act as a deterrent to international tax evasion.

D. CONCLUSION

In this study, the anatomy of tax avoidance and evasion, and the case for international understanding and co-operation have been discussed at length. Such understanding and co-operation are in the larger interests of both the developed and the developing countries. It is therefore hoped that there would be necessary agreement on whatever measures that may be contemplated to deal with this problem. The measures have to be stringent and co-operation between countries complete if any degree of success is to be achieved in tackling tax evasion.

The first and the foremost requirement is to set up a committee or a panel of experts, under the aegis of the United Nations, whose assistance can be invoked by the member countries in combating tax evasion, and which can also be entrusted with the function of resolving the differences in the interpretation or implementation of the tax treaties.

Exchange of information—both of a general nature and of a specific character—is vital to combating tax evasion. Information of a general nature would consist of all such particulars as relate to income from interest, commission, royalty, rent, dividend etc., while specific information would relate to individual cases and to specific points. Every country has a programme of combating tax evasion and avoidance, and, in that context, collects information about the incomes, such as interest, dividend and rents, earned by its taxpayers. Such information would relate to the nationals of the country and the foreigners having income therein. India collects such information on a comprehensive scale. It should be possible for each country to provide in its agreements with other countries that the information collected by it concerning the nationals of such other countries should be communicated to the Governments of those countries and vice versa. Some suitable provision on a uniform basis can be included in the tax treaties with various countries to facilitate the automatic exchange of information on the lines of the provisions contained in the agreement between France and the United States of America dated 25 July 1939. Even if the tax of a country does not have provisions similar to those in India for collecting information on the various items of income in respect of its nationals and foreigners, it should be possible for that country to provide a machinery for collecting such information at least with respect to the nationals of other countries. There should not, therefore, be any difficulty in complying with the requirements of any provision that might be included in the tax treaties in implementation of an international policy of co-operation in effective measures to combat tax avoidance. The tax treaties can also provide for mutual assistance in the investigation of specific cases of suspected frauds. To achieve these objectives, the tax convention between the developed and developing countries should include an article on the lines of article 26 of the agreement between France and the United States of America, dated 28 July 1967 (see appendix).

If there is no tax treaty between two countries, a limited agreement for exchange of information may be entered into between them. The leakage of foreign exchange and economic resources through tax evasion or avoidance is usually from the developing countries to developed countries. The need for such an agreement may not, therefore, be as pressing for developed countries as it is for developing countries; and that being so, they may not be very enthusiastic about the adoption of any vigorous measures for tackling such tax avoidance. The developed countries may even impress upon developing countries that the benefits of the exchange of information would largely accrue to them; and, therefore, it would be in their interest to enter into such agreements in case they desire to adopt vigorous measures to combat tax avoidance. The participation of the United Kingdom of Great Britain and Northern Ireland and of the United States of America in the industrialization and commerce of India is by far the largest, as compared with any other country; yet, there do not exist any agreements between these countries and India. Should India consider it necessary to have a limited agreement for exchange of information with any of the developed countries, it should be possible for it to do so without any difficulty.

Commercial intelligence is a vital as any other information for dealing with problems of tax avoidance. If a country desires to set up an effective machinery to tackle tax avoidance, it has to establish suitable organization in selected parts of the world for gathering commercial intelligence. In order to be able to gather intelligence of a general or a specific nature, however, it has to receive a certain amount of co-operation and support from the Governments of the countries from which the intelligence is sought to be obtained. To achieve this end, an appropriate clause may be inserted in the agreement between the countries. To remove any doubt, it may be clarified that the intelligence collected would not, in any circumstances, relate to any trade secret, formulae, patents etc., but would be restricted only to those aspects which have a bearing on tax liability.

While these measures would facilitate detection of tax evasion at international levels, the real object of these efforts would not be achieved if there were no co-operation among the countries concerned in the matter of levy and collection of tax dues. Recovery of tax dues beyond territorial barriers is a problem that needs to be resolved through tax treaties providing for mutual assistance in the assessment of tax liabilities of non-residents and in recovering the tax dues from assets situated in the other country. Such agreements would also facilitate normal assessment and recovery of taxes even in cases where no fraud is involved.
Appendix

EXTRACT FROM THE CONVENTION BETWEEN FRANCE AND THE UNITED STATES OF AMERICA, SIGNED ON 28 JULY 1967

Article 26

Exchange of information

"(1) The competent authorities of the Contracting States shall exchange such information 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 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 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 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;

"(3) The application will be accompanied by such documents as are required by the laws of the State making the application to establish that the taxes have been finally determined.

"(4) If the revenue claim has not been finally determined, the State to which application is made will take such measures of conservancy (including measures with respect to transfer of property of non-resident aliens) as are authorized by its laws for the enforcement of its own taxes.

"(5) The assistance provided for in this Article shall not be accorded with respect to citizens, corporations, or other entities of the State to which application is made."

Article 27

Assistance in Collection

"(1) The two Contracting States undertake to lend assistance and support to each other in the collection of the taxes to which the present Convention relates, together with interest, costs, and additions to the taxes and fines not being of a penal character according to the laws of the State requested, in the cases where the taxes are definitely due according to the laws of the State making the application.

"(2) In the case of an application for enforcement of taxes, revenue claims of each of the Contracting States which have been finally determined will be accepted for enforcement by the State to which application is made and collected in that State in accordance with the laws applicable to the enforcement and collection of its own taxes."
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