

# eJournal of Tax Research

Volume 11, Number 3  
Special Edition: 10<sup>th</sup> Anniversary Edition

December 2013

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# eJournal of Tax Research

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# **eJournal of Tax Research**

## **PUBLISHER**

The School of Taxation and Business Law (Atax) is part of the Australian School of Business at the University of New South Wales. We are the largest tax school in any university in Australia, bringing together a team of expert academic staff with backgrounds in law, commerce, tax, accounting and economics. At Atax, we're working towards building excellence in the tax profession, looking at tax from both a theoretical and practical perspective.

## **EDITORS' NOTE**

The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

## **SUBMISSION OF ORIGINAL MATERIAL**

Submission of original contributions on any topic of tax interest is welcomed, and should be sent as an email attachment (Microsoft Word format) to the Production Editor at <ejtr@unsw.edu.au>. Submission of a manuscript is taken to imply that it is an unpublished work and has not already been submitted for publication elsewhere. Potential authors are requested to follow the "Notes to Authors", which is available from the journal's website.

## **WEBPAGE**

Current and past issues of the *eJournal of Tax Research* are available via the journal's website:  
<http://www.asb.unsw.edu.au/research/publications/ejournaloftaxresearch/Pages/default.aspx>

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## Editorial announcement

This is a special issue that commemorates the 10<sup>th</sup> Anniversary of the *eJournal of Tax Research*. The 10<sup>th</sup> Anniversary issue comprises papers from leading tax researchers around the world. Many members of the Editorial Board have contributed to this special issue. I also wish to take this opportunity to report some recent developments of the *eJournal*.

Firstly, and most importantly, the *eJournal* has recently been ranked an A journal by the Australian Business Deans Council (ABDC). This new and improved ranking by the ABDC is in addition to the continuing A ranking of the *eJournal* by the Council of Australian Law Deans. This is a very good news and we will be striving hard to maintain and improve our new ranking by the ABDC.

Secondly, Eddie Wong, our valued production editor, resigned to take up a job at a law firm in late 2013. However, we are fortunate to be able to appoint Ashley Cheng, a combined-degree graduate with first class honours in economics, to a fixed-term production editorship. We are confident that Ashley will continue the good work of previous production editors.

Thirdly, I wish to congratulate Nolan who was appointed Winthrop Professor of Law at the University of Western Australia (UWA), a member of the Group of Eight universities in Australia, with effect from 1 January 2014. Nolan has been a coeditor of the *eJournal* since December 2010 and has made important contributions to the development of the *eJournal*. I have enjoyed working with Nolan and wish to take this opportunity to thank him. I wish him all the best in his new appointment.

Nolan's move to UWA necessitates a change in the *eJournal*'s coeditorship. I am pleased to announce that Professor John Taylor, Head of School of Taxation and Business Law (Atax) at UNSW Australia, has kindly agreed to become coeditor of the *eJournal*. John is a highly respected tax law academic who has published widely in various areas of taxation, including double tax treaties, corporate shareholder taxation, cross-border aspects of corporate shareholder taxation, taxation of income flowing through non-corporate intermediate entities, and capital gains tax. His appointment will further strengthen the reputation of the *eJournal* and I look forward to a positive collaboration with him.

Binh Tran-Nam (on behalf of John Taylor and Binh Tran-Nam)  
School of Taxation and Business Law (Atax)  
UNSW Australia

# Introduction to the 10<sup>th</sup> anniversary issue of the *eJournal of Tax Research*

Binh Tran-Nam<sup>1</sup> & C John Taylor<sup>2</sup>

## **Abstract**

This introduction intends to serve a two-fold purpose. First, it discusses the development of the *eJournal* in the past ten years. This includes the background, historical development, the editorial teams, summary statistics of past issues, and the ranking of the *eJournal*. Second, it provides a critical overview of the articles in this special issue.

## **1. BACKGROUND AND HISTORICAL DEVELOPMENT**

The birth of the *eJournal of Tax Research* (*eJournal*) ten years ago was intended to overcome three apparent problems in the publication of tax research at the time. First, because the nature of taxation is multidisciplinary, tax research has been published in a wide variety of often unrelated academic outlets, including law, accounting and economic journals. There were, and still are, few journals that specialise in publishing all aspects of taxation, including tax accounting, tax law, tax administration and tax policy. Second, many tax issues have tended to be national in terms of nature, analysis and application. Thus, it has often not been easy for tax researchers to reach a wide international audience. Third, most tax journals at that time were hard copy journals. This had necessitated delays in publication and access by readers. While these problems persist to the present day, their severity has lessened over time.

To overcome the above problems, the objectives of the *eJournal* were unambiguous from the outset. Its main purpose has been, and continues to be, to publish peer-reviewed, original, scholarly works on all aspects of taxation and from both theoretical and practical perspectives. In this sense, it serves as a channel for academics, researchers, practitioners, administrators, judges and policy makers to interact and enhance their understanding and knowledge of taxation. Its coverage is international and its emphasis is to promote timely dissemination of research and public discussion of tax-related issues. To fulfil these objectives, it was decided at the beginning that the journal would take an electronic form rather than the conventional paper-based format.

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<sup>2</sup> Professor, Head of School of Taxation and Business Law (Atax), University of New South Wales

The electronic format would not allow both timely publication of topical issues and easy access for readers around the world.

With hindsight, it is not difficult to see why Atax was the first academic unit to launch such as journal. First, Atax has been one of the few academic units in the world specialising in tax education and research. It was certainly the first university department in Australia to produce tax graduates at all levels (bachelor, master and doctoral). Second, members of its academic staff include experts in tax law, tax accounting and tax economics. Their research covers a wide area ranging from tax technical to tax policy. Third, as Atax's main mode of delivery has been distance education. As a result, Atax was well equipped with the right personnel and technology to successfully launch an electronic journal.

The *eJournal* had a relatively very short period of gestation. It was conceived in the early of first semester of 2003 and born in the middle of the second semester of the same year. The idea of such a journal was first canvassed by the then Director of Atax, Chris Evans, with the enthusiastic support of the then Associate Director, Neil Warren, in March 2003. They saw the *eJournal* as an integral part of or, more accurately, a necessary step for the development and maturity of Atax as a tax academic institution. Rodney Fisher, a tax lawyer, and Binh Tran-Nam, a tax economist, both academics within the Atax program, were then appointed as founding coeditors of the *eJournal*. They were charged with the challenging responsibility to make the *eJournal* a reality in less than six months.

Rodney and Binh, with the assistance from Neil, worked steadily to get the *eJournal* off the ground. There were many tasks that needed to be completed in a short time frame. These included preparing a formal proposal for an electronic journal, obtaining an ISSN, establishing an editorial board, designing the journal style and template, developing the reviewer's report and assignment of copyright forms, approaching potential authors for the inaugural issue, creating a website, etc. Some early formal requirements were completed within less than two months of the appointment of the coeditors. An ISSN was obtained from the National Library of Australia in April 2003. The inaugural Editorial Board of leading international tax scholars was established by end of May 2003.

In the second half of 2003, academic papers were being received from international researchers writing on diverse tax topics, including taxpayer attitude toward the US federal tax system, tax harmonization and competition in the EU, politics of gender in the Australian tax-transfer system, and a review of international studies of tax operating costs. These papers were formatted and edited by Darren Massey, Atax's research assistant and founding *eJournal* production editor. In August 2003, the inaugural *eJournal* website was uploaded thanks the work of Glen Jeffrey, Atax's educational designer and electronic learning officer. The first issue of the *eJournal* was officially launched at a reception held in Atax's Coogee seaside campus on 10 September 2003. The launch ceremony was chaired by the late Justice Graham Hill, who was then Justice of the Federal Court of Australia, a strong supporter of Atax, the Patron of the

Australasian Tax Teachers Association (ATTA) and one of the most respected tax experts in the Australia.<sup>3</sup>

The *eJournal* is normally published twice a year although special or thematic issues are also occasionally published. Once a new edition has been uploaded, the production editor will send an alert email to people who have subscribed to the mailing list <ejtr@unsw.edu.au>. Subscription to this mailing list can be done by sending relevant contact details to that email address. The journal is available completely free of charge in order to maximise access by interested readers. Published papers can be downloaded and printed for reference. While the *eJournal* is typically available online only, there was an occasion when a hard copy of the journal was printed: Issue 2 of Volume 4 (2006) of the *eJournal* was devoted to the late John Raneri (an academic at Atax) to honour his contribution to Australian tax law.<sup>4</sup> A hard copy of this issue was printed and offered as a present to John's widow in a tribute gathering.

## 2. THE EDITORIAL TEAM

The creation and operation of a journal is truly a joint product of dedicated teams and individuals, including the coeditors, production editors, guest editors, members of the editorial board, authors, reviewers, and supporting IT staff. Over the past ten years, there have been continuing changes to the membership of the editorial teams of the *eJournal*. The full list of coeditors, guest editors and production editors is given in Table 1.

**Table 1: eJournal coeditors, guest editors and production editors since 2003**

	Name	Year	Note
<b>Co-editors</b>	Rodney Fisher Binh Tran-Nam	2003–2004	Rodney resigned from Atax to take up an appointment with Ernst & Young
	Binh Tran-Nam Michael Walpole	2004–2010	Michael resigned from his position to become a coeditor of the <i>Australian Tax Review</i>
	Nolan Sharkey Binh Tran-Nam	2010–2013	Nolan resigned from Atax to take up a chair at UWA
	John Taylor Binh Tran-Nam	2013 onwards	

<sup>3</sup> See, for example, Justice Michael Kirby, 'Justice Graham Hill and Australian Tax Law', Inaugural Justice Graham Hill Memorial Lecture, *Taxation Institute of Australia Annual Conference* (Hobart, 2007), <http://www.grahamhillaward.com.au/web/speech.pdf>.

<sup>4</sup> See Michael Walpole and Binh Tran-Nam, 'Preface – Editors' Notes' (2006) 4(2) *eJournal of Tax Research* 97.



<b>Guest coeditors</b>	Reuven Avi-Yonah	2006, Vol 5, No 2	Proceedings from the International Network for Tax Research (INTR)'s inaugural <i>Tax and Development Conference</i> held at University of Michigan in 2006
	Michael Walpole	2011, Vol 9, No 2	Partly proceedings from Atax's <i>GST Conference</i> held in Gold Coast in 2011
	Kathrin Bain	2011, Vol 9, No 3	Proceedings from the <i>Double Taxation Treaty Conference</i> held at Chinese University of Hong Kong in 2010
	Neil Warren	2012, Vol 10, No 1	Proceedings from the <i>State Funding Forum</i> held in Canberra
	Margaret McKerchar Michael Walpole	2012, Vol 10, No 2	Proceedings from the <i>International Tax Admin Conference</i> held in Sydney in 2012
<b>Production editors</b>	Darren Massey	2003–2004	Darren resigned from Atax to take up an appointment at the Reserve Bank of Australia
	Zaid Crouch	2005–2006	Zaid left Atax to become a social worker
	Cindy Chan	2007–2009	Cindy resigned from Atax to become a law writer for CCH
	Kathrin Bain	2009–2012	Kathrin was appointed a full time academic with Atax
	Edmond Wong	2012–2013	Edmond resigned from Atax to work for a law firm
	Ashley Cheng	2013 onwards	

Sources: Past issues of the *eJournal*.

The *eJournal* has been served by an outstanding Editorial Board consisting of leading tax scholars and researchers around the globe. Sadly the intervening years have seen the untimely passing of two members of the inaugural board. At the same time, it has been necessary to expand the membership of the board to order to gain wider national and international coverage. The changes in the membership of the board are summarised in Table 2.

**Table 2: Membership of the editorial board of the eJournal since 2003**

Name	Year	Note
Robin Boadway, Queen's University	2003	<p>Passed away in 2005<sup>5</sup></p> <p>Now Monash University</p> <p>Now Monash University</p> <p>Passed away in 2013<sup>6</sup></p> <p>Now UNSW</p>
Cynthia Coleman, University of Sydney		
Graeme Cooper, University of Sydney		
Professor Robert Deutsch, UNSW		
Chris Evans, UNSW		
Judith Freedman, Oxford University		
Malcolm Gammie, Chambers of Lord Gribner QC, London		
Justice Graham Hill, Federal Court of Australia		
Jeyapalan Kasipillai, Universiti Utara Malaysia		
Rick Krever, Deakin University		
Charles McLure Jr., Stanford University		
John Prebble, Victoria University of Wellington		
Joel Slemrod, University of Michigan		
John Tiley, Cambridge University		
Jeffrey Waincymer, Monash University		
Neil Warren, UNSW		
Robin Woellner, University of Western Sydney	2013	
John Hasseldine, University of New Hampshire		
Dale Pinto, Curtin University		
Adrian Sawyer, University of Canterbury		

Sources: Past issues of the *eJournal*.

<sup>5</sup> Justice Hill's untimely passing in 2005 was mourned by the community of tax experts, academics and researchers alike. See Binh Tran-Nam and Michael Walpole, 'Editorial Announcement' (2005) 3(2) *eJournal of Tax Research* 146, and Patrick Gallagher, 'Obituary – The Honorable Justice D. Graham Hill', (2005) 3(2) *eJournal of Tax Research* 147.

<sup>6</sup> J Professor Tiley's sudden passing was acknowledged in Binh Tran-Nam and Nolan Sharkey, 'Editorial Announcement' (2013) 11(2) *eJournal of Tax Research* 134. A special issue of the *eJournal* honouring his many contributions to tax law will be forthcoming in 2014.

Finally, it is worthwhile to note that the technological aspects of the *eJournal* have been well supported by Atax's IT specialist staff including Glen Geoffrey (2003 to 2004), Chris Katselas (2004 to 2010) and Margaret Connor (2011 to date).

### 3. SUMMARY STATISTICS OF PAST ISSUES

The *eJournal* has published 11 volumes and 25 issues from 2003 to 2013 (including this special issue). The publication data from the *eJournal* is now sufficiently substantial to enable a comprehensive statistical analysis. However, within the limited scope of this brief review, it is adequate to provide a simple, descriptive analysis of the data. The basic statistics are summarised in Table 3. Note that the present issue (this special issue) is included in Table 3. Note also that any classification of papers into tax policy, administration, law or other necessarily involves a certain degree of subjectivity. For example, an article on double tax agreements could be equally classified as a tax policy, tax administration or tax law paper. The other category involves mainly research methodology of tax education.

Among the 25 issues there were six (or 24 per cent) that are thematic, mainly proceedings from conferences around the world, as already indicated in Table 1. The mix of papers appears to be normal, reflecting the expected interests of tax researchers. Tax policy is most popular, followed by tax administration and then tax technical. Of the total 136 articles published, there were 68 (or 50 per cent) tax policy papers, 36 (or 26 per cent) tax administration papers and 24 (or 18 per cent) tax law papers. Finally, the average length of a paper is just over 24 pages, which represent the normal size of an ordinary tax research article.

**Table 3: Summary of basic publication data**

Year	No of issues	No of tax policy papers	No of tax admin papers	No of tax law papers	No of other tax papers	No of pages*
2003, Vol 1	2	5	1	2	0	155
2004, Vol 2	2	6	4	1	2	262
2005, Vol 3	2	5	3	2	0	329
2006, Vol 4	2	2	1	5	0	191
2007, Vol 5	2	7	2	1	0	260
2008, Vol 6	2	3	2	2	2	190
2009, Vol 7	3	4	2	2	0	197
2010, Vol 8	3	5	2	2	0	249
2011, Vol 9	2	8	3	5	0	354
2012, Vol 10	2	13	12	0	1	652
2013, Vol 11	3	10	4	2	3	446
All	25	68	36	24	8	3,285

Sources: Past issues of the *eJournal*.

\* Excluding editorial announcements, etc.

#### 4. RANKING OF THE *EJOURNAL*

Any discussion of the development of *eJournal* would not be complete if it did not consider the *eJournal*'s ranking. Journal ranking is a relatively new process in Australia and this has been controversial to say the least. When the *eJournal* was first launched in 2003, there was no 'official' journal ranking. For a number of practical reasons, universities and the government relied on counting the number of refereed journal articles (called C1 publications) as a main measure of research productivity. In fact, the Commonwealth Department of Education, Science and Training (DEST) used to

employ C1 publications without ranking as one criterion for allocating research funding to Australian universities.

The current trend toward explicit and official rankings of journals has its genesis in the Coalition federal government's Research Quality Framework (RQF) framework, which was modeled on Research Assessment Exercise (RAE) of the United Kingdom (UK). An implicit element of the RQF is the ranking of journals as an indicator of research quality. Soon after its federal election victory in 2007, the Australian Labor Party (ALP) government launched its Excellence in Research for Australia (ERA) initiative in February 2008. As a response to the ERA, the Australian Business Deans Council (ABDC) released several lists of journal ranking in April 2008. This was followed by the Australian Research Council (ARC)'s release in June 2008 of a draft journal-ranking list involving more than 19,000 journals. Subsequent to the launch of the ERA 2008 list, the Council of Australian Law Deans (CALD) published its own list of law journal ranking in January 2009.

In February 2010, the ARC released its revised ERA journal list in which academic journals of all disciplines are ranked into four tiers in descending quality: A\*, A, B and C. Both the ERA 2008 and 2010 were controversial, especially from the perspective of tax academics.<sup>7</sup> Due to pressure from many sources, Senator Kim Carr, the then ALP Minister for Innovation, Industry, Science and Research abolished the ERA prescriptive ranking of journals in his ministerial statement on 30 May 2011.<sup>8</sup> The next full round of ERA is scheduled to occur in 2015 and, since the return of the Coalition to federal government in late 2013, there have been signs that a new ERA list of ranked journals may be on its way.<sup>9</sup> Note also that the CALD list is no longer available while the ABDC list has been revised on a regular basis.

How has the *eJournal* fared in the various lists of journal ranking? It has been suggested that taxation journals tend to suffer in any journal ranking exercise because of its multidisciplinary and country-specific nature. As a result, one of the most fundamental problems in tax journal ranking is that of disciplinary classification.<sup>10</sup> Some tax journals are classified as interdisciplinary, others as a sub-discipline of law, accounting, economics or finance. Thus, tax journals may be ranked at a level lower than their quality deserves. In addition, the *eJournal* would further suffer as it is very new and an electronic journal.

As expected, the initial rankings produced a mixed, but mainly poor, outcome for the *eJournal*.<sup>11</sup> Using an arbitrary (and unstated) ranking methodology, the ERA 2008 list classified the *eJournal* in the Accounting, Auditing and Accountability group and gave it a C ranking. In the 2008 ABDC journal quality list where no methodology was explicitly discussed, the *eJournal* also scored a C ranking within the Accounting and Finance discipline. Using the same bands as the ARC and a more well defined ranking methodology, the CALD classified the *eJournal* in the taxation field and gave it an A

<sup>7</sup> See, for example, Kalmen Datt, Alfred Tran and Binh Tran-Nam, 'Ranking of Tax Journals – The Way Forward' (2009) 24(3) *Australia Tax Forum* 341, and Binh Tran-Nam and Alfred Tran, 'Ranking of Tax Journals – A Peer Perception Study' (2011) 26(2) *Australia Tax Forum* 213.

<sup>8</sup> ARC, 'Excellence in Research for Australia 2012', *Media Release 30 May 2011*, [http://www.arc.gov.au/media/releases/media\\_30may11.htm](http://www.arc.gov.au/media/releases/media_30may11.htm)

<sup>9</sup> ARC, 'ERA 2015', *Excellence in Research for Australia*, [http://www.arc.gov.au/era/era\\_2015/era\\_2015.htm](http://www.arc.gov.au/era/era_2015/era_2015.htm)

<sup>10</sup> See note 7, Datt, Tran and Tran-Nam at 343.

<sup>11</sup> See note 7, Datt, Tran and Tran-Nam at 357.

ranking. The variation of the *eJournal's* ranking in terms of its disciplinary classification provided some empirical support to the previously mentioned argument that classification matters.

At the time of the ranking, Michael Walpole and Binh Tran-Nam set out to improve the ranking of the *eJournal* in the ERA list as this national ranking is clearly the most important and influential of all. They collected evidence regarding the quality of the journal, sought the support of members of the Editorial Board (who signed a letter to the ARC requesting a higher ranking for the *eJournal*) and submitted a formal request for revision of the journal ranking. Their efforts produced a very positive outcome. In the revised ERA 2010 list, the ranking of the *eJournal* was upgraded to B. Following this promotion, the *eJournal* also received a higher (B) ranking in the ABDC 2010 list. Most recently, in the latest revision of their journal quality list, the ABDC (2013) further promoted the *eJournal* to an A ranking.<sup>12</sup>

The continuing improvement in the ranking of the *eJournal* is a testimonial to the quality and impact of its authors and their papers. This also indicates the standing and maturity of the *eJournal* as an outlet for rigorous and relevant research on all aspects of taxation. In this context, it seems appropriate to acknowledge the indispensable role of referees who have over the past ten years been contributing to the growth of the *eJournal*.

## 5. SUMMARY OF THE ARTICLES IN THIS ISSUE

To commemorate the 10<sup>th</sup> anniversary of the *eJournal*, coeditors Nolan Sharkey and Binh Tran-Nam individually approached seven leading tax scholars in the world for contribution to this very special issue. The contributors are (in order of appearance in this issue): Joel Slemrod (University of Michigan), Richard Bird (University of Toronto), Gareth Myles (University of Exeter), Richard Cullen (University of Hong Kong), Sheila Killian (University in Limerick), John Prebble (Victoria University of Wellington), and Chris Evans (Atax, UNSW). Three of them chose to offer their own work (Slemrod, Cullen and Killian) while the remaining four offered joint work with other coauthors. The scope of the contributors is international, covering all developed English speaking economies including: Australia, Canada, Hong Kong, Ireland, New Zealand, the UK and the US. Their approaches are truly interdisciplinary, including economic, legal and just pure tax. Despite their wide scope and different approaches, there is a certain degree of integration in these papers.

The lead paper, by Joel Slemrod, a public finance theorist, touches on the design of optimal tax systems from a microeconomic perspective. The central concept of his paper is notches, which refers to features of tax policy that create discontinuous jumps in the sense that incremental changes in behavior result in discrete changes in net tax liability. Consider, for example, a 2% deficit levy that only applies to individuals whose taxable annual income is \$200 000. Thus, an incremental increase of \$1 in taxable income from \$199 999 to \$200 000 will cause tax liability to increase from \$0 to \$4 000, corresponding to a marginal tax rate of 4 000! There are many different ways to classify tax notches. The most important distinction is between quantity notches (as in the above example) and characteristic notches (that arise from line drawings).

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<sup>12</sup> ABDC, *ABDC Journal Quality List 2013*, <http://www.abdc.edu.au/pages/abdc-journal-quality-list-2013.html>

Examples of characteristic notches include corporate liability (debt vs. equity) or business legal form (sole trader vs. company). Characteristic nodes include physical border notches (a sales tax may be imposed on a state/province but not on a neighbouring state/province) and time notches (capital gains tax may be imposed on assets acquired on or after a certain date but not before that date).

The paper then focuses on the mechanics of, and limitations to, estimating price elasticity using notches. These issues are somewhat too technical to be fully reported here. The author then goes on to consider the welfare costs/gains of notches. When the income tax system is perfectly flexible, notches cannot form part of an optimal tax system (where marginal tax rates should be non-negative and less than 100%). However, notches cannot be ruled out as part of an optimal tax system when the flexibility of an income tax is constrained. Another justification for using notches in tax policy design is that they may be more effective in influencing behavior. In conclusion, the author suggests that the ubiquity of tax policy notches calls for further studies into their effects on behaviour and their role in optimal tax system. Slemrod's work is a technical one, relying on some formal mathematics, including graphs. The readability of his most interesting paper would be enhanced by including more examples and verbal interpretations.

The second paper is jointly coauthored by Richard Bird, an economist, and Scott Wilkie, a lawyer. It provides a most comprehensive review of tax policy design, especially in the context of an open economy. The scope of the paper is international although many specific examples are drawn from the Canadian tax system. The paper is written in a fairly non-technical manner and aimed at a wide audience. It will be undoubtedly a useful reference for researchers who are interested in studying tax policy design. The paper consists of two main parts and each of them is briefly reviewed below.

Since section 1 of the paper expounds the traditional approach to tax policy design, only key or thought provoking points are mentioned here. In discussing revenue sufficiency, the authors draw attention to tax elasticity, which implies that to reduce revenue volatility a country should rely on a balanced set of tax instruments. To minimise the costs of taxation, in addition to broad bases and low rates, careful attention should be given to taxes on production due to their location effects. While the authors support the ability to pay approach to fairness, they also argue that the theoretical foundation for a progressive rate structure is shaky. Surprisingly they do not explicitly consider reductions in income or wealth inequality as a justification for progressive taxation.

In section 2 of the paper the authors stress the point that no country is able to design and implement its tax system in isolation. It is remarked that globalisation has tightened the constraints on tax policy associated with excessive complexity, tax avoidance and tax arbitrage. Extending the criteria of efficiency, equity and administrability discussed in section 1, the capital export and import neutrality principles are explained and recommended. The internationalisation of tax policy and administration means that good tax policy must balance a country's own social, political and economic goals and the reality of a certain degree of unavoidable mutual dependence. In conclusion, the authors suggest that the next generation of tax policy changes will need to take into account the limitations on domestic fiscal autonomy resulting from a shrinking economic world.

The third paper, by Nigar Hashimzade and Gareth Myles, both public finance economists, is concerned with the development of tax policy in the European Union (EU) in the context of its Constitution. This is, in a way, a natural follow up to the second paper on tax policy design in an open economy. The Constitution proposed by the EU in 2004 reaffirmed the EU's commitments to economic efficiency, freedom of movement of labour and capital without discrimination. In particular, the proposed Constitution also contained the principles of subsidiarity (some independent policy choices by member states) and coordination (to counteract privately rational but not socially optimal policy choices). Tax is argued to be an area of EU policy in which the tension between these principles is most severe.

An analysis of empirical evidence reveals that tax competition between member states has led to a reduction in statutory corporation tax rates and changes in the tax base. While tax harmonisation was eventually abandoned because its perceived threat to subsidiarity, it has nevertheless led to a narrower gap between the highest and lowest standard VAT rates. An analysis of the articles in the 2004 Constitution suggests that, in principle, the Constitution is economically adequate in the sense that it would have granted the EU the powers required to control tax policy and to achieve economic efficiency. However, whether efficiency can be achieved in practice depends on how the potential conflicts between subsidiarity and coordination are resolved. Again, as suggested in Bird and Wilkie's paper, the actual outcome would have emerged as a compromise for political negotiations rather than pure economic principles.

Cullen, a tax lawyer, sets out to examine Hong Kong's tax policy development in the fourth paper of this special issue. His paper provides, initially, a comprehensive review of the origins of revenue policy making in British Hong Kong. The evolution of the revenue regime during this period can be summarily described as a practical approach based heavily on land-related revenues. The current revenue regime in Hong Kong Special Administrative Region (SAR), which can be characterised by a narrow tax base, low tax rates, and simple, stable laws, has generated sufficient revenue to allow Hong Kong to build solid infrastructure, to provide good government services, to remain debt free and to accumulate huge fiscal reserves. Cullen makes an interesting observation that it is equally accurate to simultaneously describe the current Hong Kong revenue regime as a tax policy museum and a centre of revenue policy innovation.

Cullen then argues that there are several important lessons to be drawn from the Hong Kong revenue policy experience. The first, and most important, positive lesson is the use of land as a fundamental public revenue source. The second key lesson (related to the first) from Hong Kong is its minimalist, clear and easy to comply with revenue regime associated with a narrow base and low tax rates. However, there are also bad intertwined lessons to be learnt from the Hong Kong experience. First, there is revenue inflexibility in the sense that institutionalised forward revenue/tax policy planning is notably lacking. Second, there are the high on-cost effects of the land-based tax system, leading to high cost of doing business in Hong Kong. Third, there are a high percentage of Hong Kong residents living below the poverty line and a high degree of income inequality. In view of the traditional approach to tax policy discussed in Bird and Wilkie, Cullen's paper confirms that national tax policy can be a product of history and culture rather than textbook principles. His emphasis on land-related revenues is highly relevant in the world where capital and even labour are highly mobile. Despite the success of Hong Kong's revenue regime so far, the narrow tax base and lack of formal



tax policy planning by the Hong Kong authority give rise to concerns in view of Hong Kong's ageing population problem.

Tax policy planning concerns raised Cullen's paper leads naturally to the next paper on tax policy coherence by Killian, a tax law academic from Ireland. Policy coherence has been a difficult and challenging task for tax policy makers in many countries in view of the multitude of tax policy objectives and the complex relationship between tax policy and other government policies. It is also a relatively under-researched aspect of tax policy making. In the fifth paper of this commemorative issue, Killian seeks to explore tax policy coherence, or rather lack of coherence, in the case of Ireland from both national and international perspectives. She first offers a brief review of Ireland's recent tax history, describing its single-minded focus on attracting foreign direct investment (FDI) and recent adverse international publicity surrounding the low headline company tax rate and complex tax-motivated structures put in place by large multinational companies. Against this background, Killian highlights two examples of policy incoherence in a corporate tax context.

Her first example is one of external incoherence relating to a conflict between the Irish policies on tax treaties/competition and overseas development aid (which is regarded as an important part of Ireland's national psyche). By taking advantage of the absence of withholding taxes in the Ireland–Zambia double tax treaty, Irish companies can be used to reduce tax revenue collectible in Zambia not only by avoiding the payment of withholding taxes, but also by reducing taxable profit in their Zambian subsidiaries. More generally, aggressive tax competition by developed economies, including Ireland, puts pressure on developing countries to lower their own headline rates of company tax, with detrimental effects on their tax revenue collection. Killian correctly notes that this kind of policy conflict is by no means peculiar to Ireland. Further, it goes well beyond the traditional scope of tax policy makers for resolving this kind of external policy incoherence.

Her second example is more domestically focused and can be regarded as one of internal incoherence. She explains how Section 84 of Ireland's *1976 Corporation Tax Act*, which was intended to make it easier for Ireland to tax profits by preventing tax avoidance, has in fact inhibited Ireland's ability to tax the profits of lending banks, thus resulting in a reduction in overall tax collection. It is argued that this kind of internal incoherence is created by taxpayers and their advisors, and enabled to grow by the tax policymaker's inaction. As a conclusion, Killian remarks that Ireland's successful record in attracting FDI over the past 30 years may have led to a form of tax policy capture which prevents innovation in corporate tax policies.

The paper by Killian remarks on conduit companies, and this topic is further explored in the sixth paper by Sarah Jain, John Prebble (both of whom are tax law academics) and Kristina Bunting, a law clerk. In this paper the authors examine conduit companies and beneficial ownership and seek to demonstrate that the test of substantive business activity in claims for relief under double taxation treaties is inherently illogical. The paper begins by reviewing the rationale for double taxation treaties (avoiding taxing cross border transactions twice), conduit companies and beneficial ownership. A conduit company established in a country that is party to such a treaty can in principle take advantage of the benefits conferred by the treaty even though the company is in effect operating on behalf of residents in another country(ies). The Organisation for

Economic and Co-operation and Development (OECD) Model of Convention attempts to frustrate this strategy by anti-avoidance rules known as the ‘beneficial ownership’ test. The OECD Model of Convention follows the traditional and formal legal approach that views companies as not only the legal but also the beneficial owners of their income.

Since the courts are unable to apply the beneficial ownership test literally, they tend to adopt surrogate tests such as ‘substantive business activity’ or ‘dominion’ test. The origin of the substantive business activity test, also known as the ‘economic activity test’, has its origin in the legal determination of whether domestic straw companies and foreign base companies are separable taxable entities. The application of this test has been extended by the OECD, the German legislature and the courts since the late 1980s. The authors argue that, as matter of linguistic logic, company law, and economic analysis, beneficial ownership is incapable of fulfilling its anti-avoidance role. Further, because ownership and activity are not necessarily related in a causal way, the substantive business activity test can never be considered as a coherent surrogate for the beneficial ownership test. As a medium-term solution to this problem, it is recommended that all formal, technical tests be abandoned, and that beneficial ownership provisions be interpreted as anti-avoidance rules.

The final paper in this special issue is an analysis of the underutilisation of wealth as a tax base. It is written by a tax practitioner, Natalia Chatalova, and a tax academic, Chris Evans. The paper starts by suggesting that wealth is the least utilised of the three accepted tax bases: income, expenditure and capital/wealth. (While this is intuitively true, the extent of underutilisation of wealth taxes will be more apparent if empirical evidence on distribution of tax burden by tax base is provided.) The next section of the paper discusses different forms of wealth tax (taxes on the holding or stock of wealth, on the transfer of wealth and on wealth appreciation), tax design issues (tax base, unit and rates), policy rationale, and administrative obstacles against wealth taxes. In particular, it is argued that wealth taxes satisfy both efficiency and equity criteria for good tax policy although the evidence cited is somewhat qualitative rather than quantitative. Two major administrative problems, namely, disclosure and valuation, that prevent the spread of wealth taxes, are also further explored.

The next section of the paper examines global practices in wealth taxation by both developed and developing countries. Very few countries apply wealth taxes and, in terms of specific form, wealth transfer taxes are currently more common than net wealth taxes. In the OECD countries, two key related trends have emerged. First, both net wealth and wealth transfer taxes have been narrowed to ease the administrative burden. Second, again designed to reduce the operating costs of wealth taxes, the manner of operation of such taxes has been simplified. For developing and transition economies, little evidence is available and it is argued that such countries have opted for a VAT rather than wealth taxes. One interesting tax policy tool in wealth taxation by developing country is a corporate net wealth tax, imposed by a number of South American countries. In conclusion, the authors observe two broad trends in developed economies, namely, continuing simplification of wealth tax law and administration, and identification and implementation of more efficient wealth taxes. Their analysis is convincing but it would be more complete by including capital gains tax (which is stated by the authors to lie outside the scope of their paper).

# Buenas notches: lines and notches in tax system design

Joel Slemrod<sup>1</sup>

## ***Abstract***

A wide range of tax policies create discontinuous jumps—*notches*—in the choice set of individuals and firms, arising when incremental changes in behavior cause discrete changes in net tax liability. This paper presents a taxonomy of different types of notch policies. It then discusses the mechanics of, and limitations to, estimating structural parameters using notches. Next, it considers the welfare consequences of notches and their role in optimal tax design. It concludes by speculating on why notches persist. Notches are shown to be welfare inferior absent considerations of administrative cost or salience.

## **1. INTRODUCTION**

A wide range of tax policies create discontinuous jumps—*notches*—in the choice set of individuals and firms, because incremental changes in behavior cause discrete changes in net tax liability. Recently, along with budget-set kinks, notches have attracted considerable attention on the grounds that the local behavioral response to their presence can provide especially convincing identification of the effect of taxation.<sup>2</sup>

Although this paper addresses tax policy, notch-like policies appear in other areas of economic policy. For example, certain regulations apply only to firms above a certain

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Helpful comments on an earlier draft, dated March 22, 2010, were received from participants in the tax colloquia at New York University and the University of Pennsylvania. I am especially grateful to David Agrawal, Mihir Desai, Michael Gideon, Mitchell Kane, Henrik Kleven, Michael Knoll, Leandra Lederman, Chris Sanchirico, Dan Shaviro, and Reed Shuldiner for helpful conversations on related matters, and to Jongsang Park and Eleanor Wilking for research assistance. Revised portions of an earlier draft of this paper appear in *Tax Systems*, co-authored with Christian Gillitzer, MIT Press, forthcoming.

<sup>2</sup> Kinks in budget sets, a common feature of graduated income tax schedules, feature discontinuous marginal tax rates but not discontinuous jumps in the choice set itself; see Chetty, 2009; Chetty et al., 2009; Saez 2010.

size.<sup>3</sup> Earned income above a certain threshold renders one ineligible for Medicaid, which provides a basic set of free or subsidized medical services.<sup>4</sup> Notches appear commonly outside of government policy, as well. For example, nonprofit organizations often publicize the names of donors and assign ‘titles’ (eg ‘leader,’ ‘founder’) according to brackets of gifts.<sup>5</sup> Businesses often offer quantity discounts that create a notch, such that purchasing one extra unit discretely lowers the total price. Incentive contracts often include bonuses for reaching particular targets, and/or penalties for failing to reach certain quotas.<sup>6</sup>

In this paper I offer a critical review of tax policy notches, and the lines that create them. I begin, in Section 2, with a taxonomy of the wide range of policies that create notches. Sections 3 and 4 address some analytical and normative issues, respectively, raised by notches. Section 5 discusses the roles of different types of policy notches in optimal tax design. Section 6 concludes.

## 2. A TAXONOMY OF TAX NOTCHES

Tax notches come in many varieties. Perhaps the most important distinction is between what I will refer to as *quantity notches* and *characteristic notches*.

### 2.1 Quantity Notches

The simplest example of a notch arises when tax liability is a discontinuous, or step, function of the size of the quantity aspects of a tax base, conditional on the rules that determine the size of the base. Thus, it concerns the form of the  $T(B)$  function, where  $T$  is the tax liability and  $B$  is the size of the tax base, be it taxable income, retail sales, square footage, or some other base. I will refer to this type of notch as a *quantity notch*.

In principle, a notch can be built directly into the function that maps the tax base into tax liability.<sup>7</sup> A quantity notch can also occur when an incremental change in income triggers a discrete change in, for example, the value of a credit. Consider the US Saver’s Credit, enacted in 2001, that provides for a nonrefundable credit equal to a percentage of (capped) contributions to retirement savings accounts. The Saver’s Credit design features a notch because the percentage credit rate is a discontinuous function of adjusted gross income. For example, a married couple filing jointly with income of \$30 000 receives a 50 per cent tax credit on up to \$2 000 of deposits to a retirement account, but receives only a 20 per cent credit if income is \$30 001 or more. Thus, reporting an extra dollar of adjusted gross income can cause a loss in tax credits of as much as \$600: there is a notch

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<sup>3</sup> See Kaplow (2013) for examples.

<sup>4</sup> See, for example, Yelowitz (1995).

<sup>5</sup> Harbaugh (1998a, 1998b) shows that donations bunch on the low side of the brackets, and characterizes the notch design that maximizes contributions, and Lacetera and Macis (2010) show the same kind of pattern for the frequency of blood donations in Italy, where there is public recognition for the frequency of donations above a threshold.

<sup>6</sup> See Oyer (1998).

<sup>7</sup> Slemrod (1985) provides evidence of bunching within the very small brackets that arise in the US income tax when taxpayers use the tax table to calculate liability, and argues that in this case bunching is a symptom of tax evasion.

in tax liability net of the Saver's Credit as a function of income.<sup>8</sup> The original version of the American Recovery and Reinvestment Act of 2009 contained a substantial notable notch: an \$8 000 tax credit for first-time purchasers of a primary residence whose income did not exceed \$75 000 for singles and \$150 000 for married couples; when extended in 2010 the notch was replaced by an income-related phaseout, substituting kinks for a notch. The Child and Dependent Care Credit has a phase-out range with several notches, so that within this range the percentage of expenses allowed as a credit falls by 1 per cent for every \$2 000 of adjusted gross income above a threshold. The phaseout of tuition deductions features two notches in adjusted gross income.

Quantity notches can be triggered by incremental changes in tax bases other than income. The Israeli municipal property tax, known as the *arnona*, has separate tax rates per square meter for different size categories. For example, in 2010 in Zone C of Jerusalem, the annual rate of tax was NIS 40.68 for apartments of up to 120 square meters and NIS 54.70 for apartments of more than 120 square meters, thus creating a notch equal to NIS 1 682.40 at 120 square meters.<sup>9</sup> The same feature applies to other property tax systems, both in the United States and outside of it. When the first marginal rate is effectively zero, the apparent objective of the notched tax schedule is to exempt low-value properties, for equity or administrative cost-saving reasons, and to deny the tax saving provided by the exemption to higher valued, taxable properties. When the first rate is positive, the objective is simply to recover the infra-marginal tax break for higher valued properties. This objective could alternatively be achieved, as it is in US income tax rates, by having a higher marginal tax rate for some bracket of income so that the average tax rate can 'catch up' to the higher marginal tax rate.

Notches can assume two shapes: a *pure notch* features identically sloped budget segments on either side of the notch point; with a *zigzag notch*, the slopes of the two budget segments differ. For example, the Israeli *arnona* is a zigzag notch with a higher marginal tax rate above the threshold; the second part of the tax rate schedule is what it would be if the higher marginal tax rate applied to the whole range of floor space.

## 2.2 Characteristic Notches

The other kind of notch, which I denote a *characteristic notch*, determines whether a given action or event falls within a tax base or what tax rate applies. Thus, it applies to a tax function where  $T=T(B,C)$ , where  $C$  is a vector of characteristics of the base, and the  $T(\cdot)$  is a step function of  $C$ .

To discuss the wide variety of characteristic notches, I appeal to the venerable framework in journalism for information gathering known as the Five Ws. This framework holds that, in order for an article to be complete, it must address five questions: Who (was

<sup>8</sup> Ramnath (2013) provides evidence of significant bunching of reported taxable income around the taxable income notches created by the Saver's Credit, especially for those returns with business income, whose net value is subject to more taxpayer discretion.

<sup>9</sup> The *arnona* rates were taken from [http://www.jerusalem.muni.il/jer\\_main/defaultnew.asp?lng=2](http://www.jerusalem.muni.il/jer_main/defaultnew.asp?lng=2), accessed on 1/4/2010; they have been changed since. Anecdotally one hears that the *arnona* notch induces some people to buy two adjacent apartments of less than 120 square meters and knock down the separating walls to create one dwelling for living, but not property tax, purposes.

involved)? What (happened)? When (did it take place)? Where (did it take place)? Why (did it happen)?

Similar questions apply to the determination of most tax bases. Consider a retail sales tax. The tax liability of a retail firm depends on the volume of its sales and also generally on whether the sales are taxable or tax-exempt (what?), in which state the sales were made and the consumption occurred (where?), in which tax year the sales were made (when?), and which firm made the sales and the identity of the purchaser or receiver of income (who?).

In principle, most of these arguments of the tax liability function are continuous variables. This is obvious for the volume of sales, where a discontinuous relationship between tax liability and the volume of sales (of, say, a given retail establishment) would constitute a quantity notch, but is also generally true for the other arguments that may create characteristic notches. The location of a retail sale can be represented continuously with latitude and longitude (and, in principle, altitude). Firms may be characterized by size. The time of sale has a day, hour, and so on. Most characteristics of a good or service can also be measured continuously—how much salt is in a can of soup, what hexadecimal color code applies to a pair of trousers, etc. This is not to say that in all cases these aspects can be easily measured or even are always conceptually clear, as evidenced by the ongoing controversies about where an Internet sale takes place. For reasons discussed later, the who, what, where, and when of tax base determination are generally subject to notches and lines. Economic analysis of the policy issues that arise in this area is scarce, although under the moniker ‘line drawing’ it is a persistent theme in the legal tax literature.<sup>10</sup>

### 2.2.1 Income Determination and Classification

A non-capricious income tax system must have procedures for distinguishing whether a particular transaction or other aspect of taxpayer behavior generates taxable income or loss (or, more generally, whether a separate tax rate applies) is subject to myriad categorizing lines that create notches. Whether a transaction triggers ordinary income or preferentially taxed capital gains, whether a form of compensation is an untaxed fringe benefit or taxable salary, whether a contribution is deductible or not, whether the cost of raising capital is (deductible) debt or (nondeductible) equity are just a few examples. All of these categories create lines that are generally based on characteristics and, therefore, create notches in choice sets; because, close to a line, a small change in a characteristic discretely changes the tax treatment.

In almost all such cases the tax code and/or regulations establish a series of tests that determine on which side of a tax/tax-exempt or regular-tax/preferred-tax line a case lies. These tests are invariably multi-dimensional. Moreover, in almost all cases the ruling is either-or; for example, a corporate liability is, for tax purposes, either debt or equity. In

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<sup>10</sup> Much of this literature is normative, concerning the appropriate placement of a specific distinguishing line, such as between debt and equity finance. With some exceptions, the criterion is not explicitly social welfare, but how closely the line reflects existing law and regulations, which may be instrumentally related to welfare. Weisbach (1999, 2000) are exceptions to both of these generalizations.

some cases the tax treatment depends on a characterization that is an artifact of law and is by its nature essentially discrete. The classification of business entities is an example; crossing a characteristic line between a partnership and a corporation triggers a discrete change in tax treatment, but it is difficult to think of a meaningful sense in which the tax treatment could be made continuous.<sup>11</sup>

### 2.2.2 Commodity Characteristics

A non-capricious tax system must have procedures for distinguishing among goods subject to different tax rates, and real-world consumption tax systems do that by appealing to the characteristics of the commodities. This implies that, although characteristics may be conceptually continuous, in characteristics space there are lines that determine where the discontinuous changes in tax status occur: where the notches lie.

For example, the retail sales taxes of US states often exempt food but not restaurant meals, requiring the tax law to draw a line between the two categories. This is done by appealing to a set of characteristics of restaurant meals and grocery purchases; the line must be precise when, for example, grocery stores sell pre-prepared meals that may or may not be eaten on the premises, set up in-store salad bars, or provide nearby tables, silverware, and napkins. This issue was recognized, but for the most part not pursued, in the early optimal taxation literature. For example, Stiglitz and Dasgupta (1971, p. 165) note that it is administratively difficult to have separate tax rates for every commodity, although in general an optimal tax structure would require good-specific tax rates; they note that as a result ‘almost all tax systems group commodities into fairly wide classes.’<sup>12</sup> Barzel (1976) stressed that tax statutes cannot cover all of the multiple dimensions of commodities, thus inducing substitution away from taxed attributes and into untaxed attributes.

Characteristic lines may create incentives for firms to introduce new goods that are more intensive in the high-tax characteristic but (just) on the low-tax side of the line, allowing the consumer to obtain more of the high-tax characteristic without triggering the tax liability associated with the high-tax good. This can occur through marginal product shifting around existing goods, as in supermarkets that provide restaurant-like characteristics via in-store salad bars. These are local adjustments, as the goods provided are only slightly socially inferior to the goods they replace. Or firms may generate entirely new goods, situated just on the low-tax side of the line. For example, the preferential tax treatment of motorcycles in Indonesia led to the creation of a new type of motorcycle with three wheels and long benches at the back seating up to eight passengers—car-like but not so car-like as to be taxed as cars. When Chile imposed much higher taxes on cars than on panel trucks, the market soon offered a redesigned panel

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<sup>11</sup> I thank Mitchell Kane for raising this point with me.

<sup>12</sup> Stiglitz and Dasgupta (1971, p. 165) also mention that it is often impossible for tax authorities to differentiate between different kinds of income such as, in unincorporated enterprises, differentiating between the labor of the owner, returns to his capital, and pure profits, and thus they are generally taxed at the same rate, ‘even though the optimal tax structure almost certainly would instruct us to tax them differentially.’ They note this to motivate their result that production efficiency is not necessarily part of an optimal tax system when there are constraints on levying differentiated taxes on goods or factors.

truck that featured glass windows instead of panels and upholstered seats in the back.<sup>13</sup> Depending on the location of the line, these new goods may not be socially optimal, although they are privately optimal given the abrupt differential tax liability generated by the line.

In some cases tax treatment is differentiated on the basis of one quantifiable characteristic of a commodity. An example of this is the US Gas Guzzler Tax, under which high-performance cars are subject upon initial sale to a per-vehicle tax that is higher the lower is the fuel economy of the car, a car characteristic. For cars (but not light trucks or SUVs) that get less than 22.4 miles per gallon, the tax levy rises discontinuously as the miles-per-gallon rating crosses downward from a (rounded) 0.5 decimal ending to a 0.4 decimal ending, with the change in the tax amounting to as much as \$1 300 and averaging about \$800. Note that this tax schedule is discontinuous in miles-per-gallon even though this variable is continuous and fairly easy to measure, and the social benefit of more fuel-efficient cars is certainly not a step function. In this case basing the tax on a single characteristic is facilitated by the transparent motivation for the tax—to increase the fuel efficiency of new cars—so that the tax can be related to a measure of that one aspect of a vehicle.<sup>14</sup> Based on a similar motivation, in several countries notched taxes apply to vehicles whose engine exceeds a given size. However, as the commodity tax example illustrates, in the more common scenario the line depends on multiple, difficult-to-quantify underlying characteristics. In all commodity notch cases, though, a marginal change in some characteristic can change the classification so as to produce a discrete change in the tax consequences.

### 2.2.3 Border Notches

Physical borders that divide jurisdictions are lines that create discontinuous tax treatment depending on the location of, for example, retail sales. These discontinuities create notches in budget sets where the location of the tax-triggering event matters.<sup>15</sup> People may cross borders to buy lower taxed items.<sup>16</sup> Where a good or service is purchased, or consumed, may determine the amount of tax liability and to which entity the liability is owed. The characteristic is of varying importance to consumers depending on where they live (and/or work or otherwise visit), because this determines the transportation cost of obtaining the item. Under some conditions each consumer will buy in one place or the other depending on whether the transportation costs exceed the saving from the tax differential. We would expect few cigarettes purchases just on the high-tax side of the border, and a mass of purchases just on the low-tax side of the border.<sup>17</sup> Similar issues apply to the location of income.

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<sup>13</sup> These examples are taken from Harberger (1995).

<sup>14</sup> Sallee and Slemrod (2012) examine the consequences of this tax.

<sup>15</sup> Differential tax rates also create incentives for the location of production and taxable income for multinational corporations, but the incentives do not depend on where within a country the activity takes place.

<sup>16</sup> The incentive to do so is diminished to the extent that the retail sales tax systems are residence based. Many US states levy ‘use’ taxes at the same rate as their retail sales taxes that are triggered by out-of-state goods consumed in-state, but these are notorious for being poorly enforced.

<sup>17</sup> See Lovenheim (2008).



Clearly where a jurisdictional border lies is not a policy choice, at least not a choice made by the tax authorities. It does, though, raise the question of why relatively high sales tax rate jurisdictions do not levy continuous tax rates at borders so that the closer to a low-tax neighboring jurisdiction, the lower the tax. For example, why doesn't high-alcohol-tax Massachusetts, which borders low-tax New Hampshire, levy lower excise taxes the closer one gets to the New Hampshire border? This policy would just codify what is effectively true when the full price includes transportation costs—a lower price for those who live close to New Hampshire—but keeps more revenue for Massachusetts. If not everyone drives to New Hampshire, there are horizontal equity and efficiency issues, but these issues arise even with no geographical differentiation. The welfare economics of border notches is unique because each government jurisdiction presumably cares only about its own residents' welfare and there may be fiscal externalities across jurisdictions.<sup>18</sup>

#### 2.2.4 Time Notches

The use of accounting periods, generally years, implies that there will often be discrete changes in tax treatment (ie notches) with respect to certain activities undertaken at year-end versus year-start. This may occur for two reasons: (1) anticipated legislated changes in the tax rules from one year to the next; or (2) with a graduated tax schedule, a given taxpayer's marginal tax rate is expected to change because of expected changes in the tax base. In these cases, the same taxable action taken just days, or even hours apart, can trigger a discretely different tax liability.

Just as administrative considerations limit the number of distinct commodity tax rates, they limit the number of distinct tax accounting periods. The income tax accounting period is typically one year, although this is arbitrary. In some transfer systems, the accounting period is shorter because of concerns that income support must be delivered quickly to households with temporarily low income.<sup>19</sup>

Examples of the sensitivity of behavior to time notches abound. When the US top income tax rate increased from 1992 to 1993, Wall Street bonuses shifted from one-third end-of-year, two-thirds beginning-of-year, to the reverse.<sup>20</sup> When the US top capital gains tax rate increased from 20 per cent in 1986 to 28 per cent in 1987, there was an extraordinary amount of realizations at year-end 1986.<sup>21</sup> This is particularly notable because, under a realizations-based capital gains tax system like that of the United States, the tax obligation depends on the date of sale. This is generally unrelated to, for example, the date of consumption of the proceeds of the sale, which in any event is not well-defined. So the line is drawn in a space different from the arguments of individuals' utility functions.<sup>22</sup>

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<sup>18</sup> See Agrawal (2011).

<sup>19</sup> For example, in 2012 the United Kingdom piloted the Universal Credit, a social assistance program that assesses household earnings on a monthly basis in order to determine benefit eligibility, with the goal of reducing credit constraints and issues of annual over- or under-payment.

<sup>20</sup> Note that, under cash accounting for tax purposes within limits, the payment for labor income can be recorded in either year, regardless of when work was 'done'. Thus, we can expect that the substitutability of dated payments to exceed the substitutability between dated consumption.

<sup>21</sup> See Burman et al. (1994).

<sup>22</sup> Cole (2009) shows a large time sensitivity of purchases of goods—especially computers—subject to state retail sales tax 'holidays' that have become widespread in the United States.

### 2.2.5 Taxpayer/Remitter Notches

This brings us to the ‘who’ of tax base determination.<sup>23</sup> The same tax base may trigger different tax liabilities depending on some characteristics of the taxpayer or remitter of the tax. For example, under the US federal income tax there are separate schedules for four different categories of taxpayer marital status. When tax is based on family income, marriage penalties and bonuses arise where the sum of two individuals’ tax liability depends on whether they are married. Under an individual-based system, the total tax liability of a couple depends on the division of earnings between the spouses. These sharp distinctions obtain in spite of the fact that there are many dimensions to relationships among adults that are, in principle, continuous.

Remitter notches arise when tax-remitting firm characteristics, often size-related, trigger discrete changes in tax treatment. Onji (2009) discusses the Japanese VAT, where firms below a certain size threshold may opt for a favorable regime, and documents the presence of bunching in firm size right below the size threshold.<sup>24</sup> Many countries’ VATs feature thresholds, usually in terms of turnover, below which a firm need not register for the VAT.<sup>25</sup> Differentiation of tax liability based on firm size apparently violates production efficiency, which Diamond and Mirrlees (1971) showed characterized an optimal tax system under some conditions. But, as Dharmapala et al. (2011) argue, firm-size differentiation can indeed be part of an optimal tax system when there are fixed-per-firm elements in the administrative costs of running a tax system.

Permitting firms below a size threshold the option of a simplified VAT is an example of a case where the consequence of moving from one side of the notch to the other cannot be naturally continuous (ie it is difficult to imagine a continuous gradation of regular VAT rules and simplified VAT rules). It is easy to find other examples of nondiscrete tax aspects of a tax system: In the United States only corporations with greater than \$10 million of assets must file the Schedule M-3 as part of their corporate tax return, which requires a complete reconciliation from financial accounting net income to taxable income in a standardized and detailed format. Corporations with less than \$5 million of gross receipts averaged over the three previous years may use the cash method of accounting, and are exempt from the corporate alternative minimum tax. For such discrete tax-system aspects, notches are inevitable.

## 3. NOTCH ANALYTICS - QUANTIFYING BEHAVIOR WITH NOTCHES

### 3.1 Measuring Price Elasticity Using Quantity Notches

Recently, Saez (2010) and Chetty et al. (2009) have argued that the behavioral responses to kinks and notches can provide an estimate of price and income elasticity that is immune to identification concerns that plague other estimation methodologies. This advantage relies on the premise that individuals whose consumption and leisure choice are located in the neighborhood of a kink or a notch differ only in the local shape of their budget set.

<sup>23</sup> There are also ‘why’ notches; for example, in the United States and other countries a given tax understatement is subject to discretely different penalties depending on the judged intent of the taxpayer.

<sup>24</sup> See also Best et al. (2013).

<sup>25</sup> VAT thresholds are discussed in Ebrill et al. (2001, pp. 113-124).

Alternative strategies, such as the panel data methods employed by Auten and Carroll (1999) and Gruber and Saez (2002), rely on different assumptions, namely that secular changes in income year to year can be controlled for, thereby allowing the researcher to estimate a difference-in-differences parameter for the effect of a tax change. These assumptions can prove problematic in the face of income inequality or mean reversion.

At first blush, studying behavior in the neighborhood of a discrete change in tax treatment may sound like a regression discontinuity (RD) research design, where the treatment in the case of a kink is a discretely different relative price, and in the case of a pure notch is a discretely different virtual income. In RD design, one is interested in the causal effect of a binary intervention or treatment where assignment to the treatment is determined, either completely or partly, by the value of a predictor being on either side of a fixed threshold. Assuming that the association of the predictor to the outcome is smooth, any discontinuity of the conditional outcome at the threshold value can be interpreted as the causal effect of treatment.

Under some conditions, a notch can enable an RD design. Lemieux and Milligan (2008) examine the labor market effects of a Canadian social assistance program that gave recipients over age 30 a higher level of support than received by those under age 30. Because the treatment is a deterministic function of a forcing variable (age) that individuals cannot manipulate, any observed response among the treated in the neighborhood near the discontinuity has a compelling causal interpretation. However, in cases such as Saez (2010), individuals can manipulate the forcing variable, thereby violating a key assumption of RD design. For example, in the standard quantity notch the forcing variable is taxable income, which can be chosen by the taxpayer. Indeed, in tax analysis understanding the behavioral response of the forcing variable is often the *purpose* of the exercise. Nevertheless, studying the behavior of agents in the neighborhood of policy notches retains the essence of the RD advantage in that it compares the behavior of arguably similar individuals who may face different relative prices and have different virtual incomes.

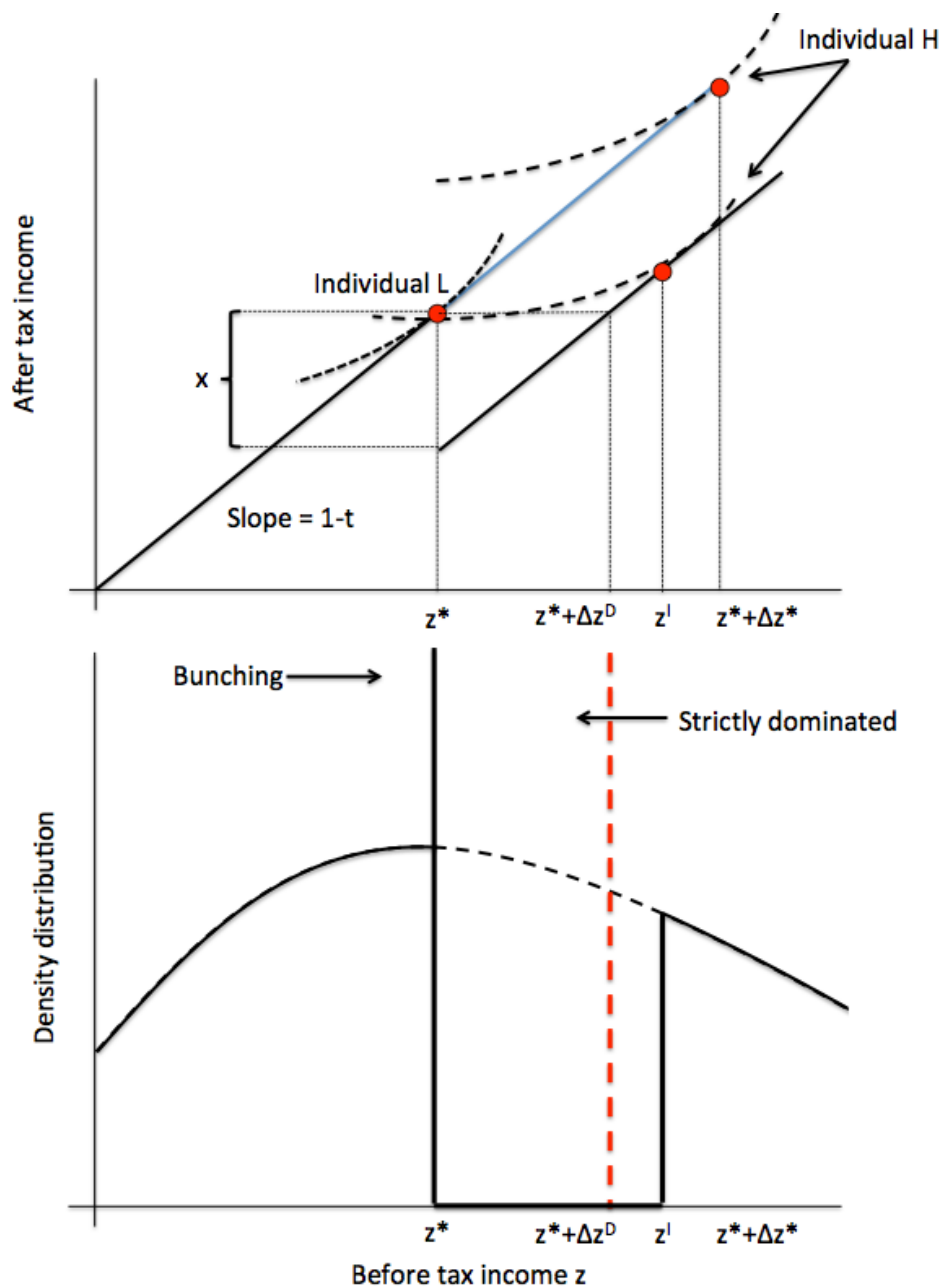
As an illustration I consider behavior in the presence of quantity notches in the space of after-tax income and before-tax income. Before-tax income represents the effort put toward earning income, and enters negatively into the utility function; in a simple model where individuals supply labor, before-tax income is simply labor income. After-tax income equals consumption, and enters positively into the utility function. A notch in this space represents a point where a small change in before-tax income yields a discrete change in consumption (after-tax income). When consumers have heterogeneous preferences and/or wage rates,<sup>26</sup> one would expect to see bunching at the more tax-attractive side of the notch. To be sure, bunching would also arise in the presence of kinks in convex budget sets. However, unlike the case of kinks, in the presence of a notch a consumer should never elect to be on the ‘wrong’ side of the notch—the density distribution should feature a ‘hole’ on the tax-disfavored side of the notch. This

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<sup>26</sup> When the choice variables are specified as after-tax income and before-tax income, heterogeneous preferences can arise from underlying taste differences as between leisure and consumption, or because the wage rate differs for given leisure-consumption preferences. Note that preferences can vary while the elasticity of response is uniform.

implication holds if we assume consumers make rational decisions and face no adjustment costs, an issue to which I return below.

To illustrate, refer to Figure 1 and consider the following notation drawn from Kleven and Waseem (2013). Imagine that individuals have quasi-linear and iso-elastic utility over before-tax earnings  $z$  and after-tax earnings  $c$ ,  $u=c-f(z)$ . Let  $f(z)$  be a function parameterized by the individual's ability and her elasticity of earnings with respect to the marginal tax rate. At the optimum,  $z$  is an increasing function of ability and a decreasing function of the tax rate, with responsiveness to the latter governed by the elasticity. Suppose a pure notch is introduced at  $z^*$ : the marginal tax rate on either side of  $z^*$  remains the same, but individuals with before-tax earnings greater than  $z^*$  incur a tax liability increased by a discrete amount. In the absence of frictions, some individuals will choose to bunch at  $z^*$ . Individual L, the person with the lowest pre-notch income who chooses to bunch, would have chosen  $z^*$  even in the absence of the notch. Individual H, the person with the highest pre-notch income who chooses to bunch, would have chosen  $z^*+\Delta z^*$  in the absence of the notch and is indifferent between  $z^*$  and the interior point  $z'$  after the tax change. A region defined by  $(z^*, z^*+\Delta z^D]$  is created by the notch where individuals could increase both leisure and consumption by electing to bunch at  $z^*$ ; this is the strictly dominated set of consumption choices. Even when the structural elasticity parameter is zero, individuals will choose to bunch instead of being in this region, unlike with a kink. A larger region,  $(z^*, z')$ , contains the strictly dominated set and defines the range of before-tax incomes that no individual is willing to choose after the tax change because the utility loss from reduction in after-tax income outweighs the utility gain from the fall in before-tax income. As a result, the distribution of before-tax earnings in the presence of the notch will feature a 'hole' in that region.

**Figure 1.**

By measuring the extent of bunching, one can deduce the implied price elasticity using a methodology similar to that used for kinks by Saez (2010). With a kink, a sudden change in relative prices at one point on the budget set induces a behavioral response: consumers on the affected budget segment substitute toward the kink, with many bunching exactly at

that point. One estimates the price elasticity by observing the largest such change in the consumption basket in the direction of the kink point; a larger maximal change implies a bigger elasticity. Formally, given a change in the marginal tax rate at the kink of  $dt$ , the compensated elasticity of earnings  $e$  can be defined as

$$e = \frac{dz^*}{z^*} \frac{1-t}{dt} \quad (3.1)$$

where  $z^*$  is the kink point and  $\frac{dz^*}{z^*}$  is the degree of bunching. To empirically estimate this quantity, one must assume a density of before-tax earnings that is smooth in the neighborhood of the kink to measure the extent of bunching that actually occurs. The elasticity can then be recovered from the equation

$$B = z^* \left[ \left( \frac{1-t_0}{1-t_1} \right)^e - 1 \right] \frac{h(z^*)_- + h(z^*)_+ / \left( \frac{1-t_0}{1-t_1} \right)^e}{2} \quad (3.2)$$

where  $h(z^*)_-$  and  $h(z^*)_+$  represent the densities of before-tax income just below and above the kink and  $B$  is the measured extent of bunching.

With pure notches, there is no explicit change in relative prices at any single point on the budget set, but there is an implicit relative price change between the tax-favored notch point and an alternative point on the tax-disfavored region of the budget set. The minimum implicit price change that causes an individual to remain on the tax-disfavored region reveals the price elasticity; the smaller the price change needed to induce a move, the more sensitive (ie the bigger is the elasticity). As with kinks, more bunching implies a higher price elasticity. For a given notch size, the shorter the length of the strictly dominated budget segment, the larger is the minimal implicit price change required to affect bunching; a small hole in the density distribution corresponds to a small price elasticity. Formally, Kleven and Waseem (2013) demonstrate that, under the standard assumptions regarding iso-elastic and quasi-linear utility, the first-order optimality condition can be rewritten as an expression containing the elasticity, tax parameters, and the degree of bunching:

$$\frac{1}{1+\Delta z^*/z^*} \left[ 1 + \frac{\Delta T/z^*}{1-t} \right] - \frac{1}{1+\frac{1}{e}} \left[ \frac{1}{1+\frac{\Delta z^*}{z^*}} \right]^{1+\frac{1}{e}} - \frac{1}{1+e} \left[ 1 - \frac{\Delta t}{1-t} \right]^{1+e} = 0 \quad (3.3)$$

Unlike the formula for kinks in Saez (2010), this expression relies on the change in average, rather than marginal, tax rates, as this is the driving force behind the behavioral response to a notch. Even when the elasticity approaches zero, the resulting estimate for the bunching interval is still positive, reflecting the fact that individuals will always avoid the strictly dominated region.

Empirically estimating the elasticity is less straightforward with notches than with kinks. With a kink, the researcher must choose some bandwidth around the kink point that defines the region containing excess mass. With a notch, the researcher must first choose the point on the tax-favored side of the notch where bunching in before-tax income begins

to occur. Then, she must choose a corresponding point on the tax-disfavored side of the notch where the ‘hole’ in the post-notch density of before-tax earnings ends. The former point is typically easier to visually identify than the latter. Kleven and Waseem (2013) exploit the fact that, absent frictions, the missing mass on the tax-disfavored side of the notch should equal the excess mass on the tax-favored side, and use this to pin down the upper bound of the excluded range.

### 3.2 Which Elasticity Are We Measuring?

#### 3.2.1 Real/Fundamental versus Avoidance Elasticities

Can patterns of bunching around notches inform our understanding of fundamental economic parameters? For example, what does bunching of consumption precisely at a time notch, after which the consumption tax rates change, reveal about the intertemporal elasticity of consumption? To answer this particular question requires one to distinguish between purchases, which are subject to an abrupt tax rate change at the time notch, and consumption. As first noted by Eichenbaum and Hansen (1990), the mapping from consumption good purchases into consumption services can be viewed as a dynamic version of the household technology suggested by Gorman (1980) and Lancaster (1966, 1975) in which consumption *goods* produce the ultimate arguments of utility functions — consumption *services* in current and future periods. Perhaps the most common interpretation of this model arises from considering durability (and storability), where consumption goods are durable and are purchased to augment the stocks of household capital. Because the marginal utility of goods purchased is decreasing in the quantity of carried-over stock, purchases that are closely spaced in time are relatively more substitutable.

This implies that the pattern of behavior around a time notch does not directly provide evidence about intertemporal substitutability, but about the combination of intertemporal substitutability and the durability (or storability) of the goods in question.<sup>27</sup> Clearly time moves in only one direction, which limits the applicability of this approach to notches in other characteristics. But the Gorman-Lancaster framework, where there exists a mapping of goods into characteristics space and characteristics alone enter the utility function, remains insightful for the interpretation of the behavioral response to notches. I expand on this point below.

The anatomy of the behavioral response to tax changes is crucial to understanding what the elasticity of taxable income is measuring. Because taxable income is a function both of the income earned from labor supply and a variety of sheltering activities, as well as decisions regarding how income is reported, its responsiveness to a tax change depends on how flexible individuals are in choosing these quantities. Broadening the tax base, for example, may limit individuals’ ability to shelter their income. This point is emphasized in Slemrod and Kopczuk (2002), who argue that the elasticity of taxable income (ETI) is a function of the tax base and therefore can be thought of as a policy-dependent, rather than as a structural, parameter. An empirical estimate of ETI should only be thought of as a measure of the responsiveness of taxable income to a change in tax rates *under the studied*

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<sup>27</sup> See Cashin (2012).

*tax regime*, and not one that may obtain in other contexts. Furthermore, Chetty (2009) argues that the implications for calculating deadweight loss differ depending on whether the response to a tax change derives from changes to labor supply or sheltering behavior because the latter is a transfer rather than a ‘real’ response.

### 3.2.2 Structural versus Nonstructural Elasticities

A further caveat to recovering structural estimates of elasticities from bunching at kinks or notches is the presence of optimization frictions. Individuals may desire to adjust their consumption to the notch point, but are unable to do so in the short term, thus diminishing the observed bunching. For example, a reduction in labor supply may require changing jobs. If we believe that such constraints matter only in the short term, then optimization frictions ‘artificially’ diminish the observed bunching, biasing downwards the estimate of long-run behavioral response. Chetty (2012) shows formally that the presence of even relatively small optimization frictions can be consistent with a wide range of intensive-margin tax price elasticities. Unlike with a kink, a notch creates a strictly dominated consumption choice set that individuals will avoid in the absence of frictions, making the discontinuities created by notches valuable opportunities for econometric identification.

The method developed by Kleven and Waseem (2013) relies on exactly this insight: the strictly dominated region should be empty in the absence of optimization frictions. Any observed mass in the dominated region can therefore be used to identify the degree to which frictions drive behavior without making parametric assumptions, and can be combined with excess mass estimates to disentangle the underlying *structural* elasticity—the responsiveness absent any adjustment frictions—and the short-run elasticity, which measures the actual observed behavioral response. Assuming that these frictions diminish in the long run, the structural parameter represents the elasticity relevant to welfare and optimal policy discussions.

Using administrative data on income tax filings, they report two findings about the responses of wage earners to notches in the Pakistani income tax system: a significant degree of bunching and many individuals located in the strictly dominated region. They conclude that while some individuals, particularly the self-employed, are responsive to the strong tax incentives created by the notches, the majority of wage earners are subject to optimization frictions.

As mentioned earlier, what triggers a tax in practice is often different from what triggers a tax liability in stylized models. For example, retail *purchases* rather than *consumption* trigger retail sales tax liability, receipt of labor income rather than the physical labor itself often determines the timing of tax liability. Sales of appreciated capital assets trigger tax liability rather than accrual of gain or consumption itself. Operational definitions of taxable income differ on many dimensions from the Haig-Simons definition of income. These tax bases, which we might call *surrogate* tax bases, may be part of an optimal tax system because of the difficulty of measuring or monitoring the otherwise optimal tax base. Most, if not all, actual tax systems have elements of surrogate tax bases. The local response to lines and notches is appropriately characterized as *tax avoidance*, in the sense of Slemrod and Yitzhaki (2002) — taxpayer efforts to reduce their tax liability that do not alter their consumption basket other than due to income effects— and gives rise to an



excess burden of avoidance as defined by Slemrod and Gillitzer (forthcoming). Substitution across elements of a surrogate tax base does not directly alter one's consumption basket although, through the function linking the surrogate tax base to the consumption basket, it may alter the effective relative prices of the latter and thereby change consumption choices.

The presence of notches in surrogate tax bases sheds light on the hierarchy of behavioral responses proposed by Slemrod (1990, 1992), which asserts that of behavioral responses, timing responses are the most elastic, followed by avoidance/accounting responses, with the least responsive being real responses such as labor supply and saving. Although much evidence is broadly consistent with the hierarchy hypothesis, a satisfactory explanation has not yet been offered. But now consider that the evidence cited in favor of a high elasticity of response, exemplified by the striking increase in capital gains realizations in advance of known increases in the capital gains tax, is response of a surrogate tax base (capital gains do not enter utility functions directly) around a notch, the notch in time at the end of a year. This largely reflects the response to effectively very high tax rates per day of postponement near the year-end notch, plus the fact that the sale itself does not constrain the time pattern of consumption. Thus the reduced-form estimates of capital gains realization elasticities do not provide direct evidence about any fundamental, or structural, parameters. The same is true for the high observed elasticity of response to sales tax holidays or expiring investment incentive provision,<sup>28</sup> where the durability of the consumer or investment good comes into play.

### 3.2.3 Why Does the Anatomy of Elasticities Matter from an ETI/ETB Perspective?

The foregoing discussion about *which* elasticity a notch analysis identifies is, at first blush, inconsistent with the spirit of the elasticity of taxable income, or tax base—that *all* behavioral responses to tax are symptoms of inefficiency, and so a decomposition of the overall behavioral response is not instructive.

This is only partially true. It is completely consistent to distinguish between short-term and long-term elasticities, a difference that will obtain in the presence of adjustment costs. This issue applies to any behavioral elasticity, although in the case of notches what is relevant is the cost of making relatively small adjustments in, say, reported taxable income.

The anatomy of behavioral response can matter for the important issue of the generalizability of behavioral elasticities derived from notch analysis. Trivially, one is learning only about local responses, so what is learned from analysis of the response to a notch in the neighborhood of \$30,000 in annual income may not apply around \$300,000; this is likely to be relatively important when avoidance responses are at issue, and especially when there are fixed costs to undertaking avoidance.

The generalizability issue also applies to the salience of notches, especially in light of the abundant evidence that many taxpayers are unaware of relevant aspects of the tax code.

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<sup>28</sup> See House and Shapiro (2008) for an analysis of the response of investment to a time-notched bonus depreciation scheme.

Apparently notches are often implemented precisely because they stand out and are more comprehensible than a schedule with multiple kinks or with continuously changing marginal incentives, and precisely when these characteristics are deemed to matter. This suggests that the implicit price response (of those who are aware of the notch) may be greater than in other situations; after all, for small responses close to the kink, the implicit price approaches infinity.

The extreme local rewards (or penalties) generated by notched budget sets also provide large incentives to smooth the tax-triggering activity across accounting periods. Just as salesmen who qualify for a bonus once they hit their annual sales target don't want to 'waste' recording sales above the target and instead shift them to the next year, some of the bunching one observes around tax notches is likely to be a symptom of intertemporal shifting, which affects how the measured elasticity enters a welfare cost calculation: the revenue implications in the 'other' periods must be accounted for to the extent that time shifting is part of the behavioral response.<sup>29</sup>

Finally, the anatomy of behavioral response also matters for the generalizability of the findings because in different situations the relative importance of the component elasticities is likely to be different. To see this, consider the example of a sales tax holiday, where for a short period of time (say a week) certain purchases (say school clothes and supplies) are exempt from sales tax. The elasticity with respect to price that one would estimate from behavior around this time notch will largely represent a purchase elasticity rather than a consumption elasticity; it would be mistaken to extrapolate this elasticity if the sales tax holiday were offered for lawn mowing services that had to be provided (in a verifiable way) within the holiday, because in that case consumption must equal purchases in each time period and thus the consumption elasticity constrains the overall elasticity. Furthermore, elasticities that include evasion response estimated in an environment of lax enforcement will not be applicable to situations where enforcement precludes evasion. In these examples the measured elasticity (ignoring the short-term long-term distinction discussed above) will be useful for welfare analysis, but not necessarily in environments that are dissimilar from the one in the case under study.

One indisputable contribution of studying the behavioral response to tax notches is the compelling demonstration that at least some people and firms do notice and react to the tax system. While this is not at all surprising to people in the field, there remain doubters that taxes matter. But the myriad documented responses to quantity, characteristic, border, and time notches put this possibility to rest. As George Bernard Shaw is alleged to have said in an entirely different context, 'Now we're just haggling over the price [response]!'

#### **4. THE WELFARE COST OF NOTCHES**

A tax notch creates a discontinuity in budget sets and, in its pure form, does not change relative prices across segments. However, for local choices between consumption baskets

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<sup>29</sup> This argument is presented in Slemrod (1990).

on different segments, a notch creates widely varying effective relative prices depending on the size of the notch and the initial distance from the notch point.

The welfare cost, or gain, of a notched policy must be measured relative to the alternative policy instruments available. For example, if the optimal income tax schedule is highly nonlinear, then a notched policy could be welfare-improving compared to a linear system.<sup>30</sup> General statements about the welfare implications of notches cannot be made.<sup>31</sup>

We can, though, say more regarding some particular situations. What are the welfare implications of a notched system when the optimal scheme is linear? Sallee and Slemrod (2012) address this question in the context of notched subsidies to fuel-efficient cars in Canada and the United States. Presumably, the positive externality to the environment is a smooth, rather than notched, function of fossil fuel emissions. As a result, the optimal Pigouvian tax correction would similarly be smooth, equal to the marginal social benefit of increased fuel efficiency, measured as a vehicle's miles-per-gallon (MPG). The US Gas Guzzler Tax features notches at each 0.5 decimal of MPG under 22.4; increasing a vehicle's MPG by 0.1 can reduce the tax liability by as much as \$1 700, and on average does by \$800. As a result, manufacturers producing cars with an initial MPG far from a notch have little incentive to increase fuel efficiency, while manufacturers with an initial MPG ending in 0.4 or 0.9 have a strong incentive to increase MPG by 0.1 that is disproportionate to the social gain generated by such a change. Increases to fuel efficiency induced by notches may even result in a welfare loss if the private costs of these adjustments exceed the social benefit of reduced emissions. Sallee and Slemrod (2012) observe bunching on the low-tax side of notches in the distribution of vehicles' fuel efficiency, and calculate the weighted-average subsidy per MPG to be \$4 720, compared to the optimal Pigouvian subsidy per MPG of \$800. Further, they calculate the social gain, net of the private cost of changing MPG, is *negative*, with a magnitude five times the net social gain from the Pigouvian incentive to improve MPG.

## 5. WHY NOTCHES?

### 5.1 Quantity Notches

Would notches be part of an optimal income tax system, if there were no particular administrative cost associated with them? The seminal optimal income tax paper of Mirrlees (1971) implies that, when the income tax schedule can be completely flexible, the answer is no. He shows that, in an optimal nonlinear income tax, the marginal tax rate always lies between zero and one, which precludes either a discrete drop or increase in after-tax income as pre-tax income increases. As Diamond (1998, p. 84) discusses, the reason for the two proscriptions is different. Marginal tax rates should not be greater than 100 per cent because 'Assuming that labor supply can be continually adjusted, there is no gain from having marginal tax rates above 100 percent since no one will have such a tax at the margin. That is, the same outcome can be achieved with taxes no greater than 100 percent.' He goes on to explain that marginal tax rates should not be less than 0 per cent

<sup>30</sup> The same statement holds for, say, kinks.

<sup>31</sup> Although, see Kaplow (2013) for a comprehensive treatment of the optimality of size exemptions for both taxation and regulation.

because: ‘It is usually presumed that preferences are such that consumption is an increasing function of the wage. Then, earnings will be nondecreasing in skill. It follows that the optimal tax structure has nonnegative marginal rates...’

However, as mentioned earlier, no theorem rules out the possibility that a notch can be part of an optimal schedule when the flexibility of the income tax schedule is constrained, say to be linear. This possibility is in the same spirit as the argument made by Blinder and Rosen (1985) that, in cases where the objective is to encourage consumption of a particular activity (in their example, charitable giving), notch schemes may be more effective than per-unit subsidies. Compared to a constant per-unit subsidy that applies to all charitable donations, a notch grant that kicks in only for those whose consumption exceeds a certain amount limits the amount of subsidy for infra-marginal giving. In principle, when revenue is costly to collect, the ideal subsidy scheme would provide a subsidy only at the margin of favored consumption but, in the absence of personalized incentive schemes or other nonlinear consumption taxes or subsidies, a notch may increase welfare.<sup>32</sup> Whether a nonlinear consumption tax, and indeed an extreme version of a nonlinear consumption tax with a notch, could be part of an optimal tax system would depend on how flexible the income tax schedule can be.

## 5.2 Characteristic Notches

Canonical optimal tax theory, which ignores administration and enforcement costs, prescribes staggeringly complex tax features such as nonlinear, age-dependent income taxes, discretely different consumption taxes for each good and service, and tax liabilities that are a function of every available variable that is correlated with earning ability (ie height, genomic information). Policy does, and should, forego many such features.

Consider first commodity taxation. In a world with administration and enforcement costs, plus continual creation and disappearance of available goods, a large number of distinct tax rates would be too costly to administer (ie infeasible). As a result, commodity tax systems inevitably feature a small number of distinct tax rates based on observable characteristics, where the domain of each tax rate is delineated by a line, which causes a notch. Characteristics are a relatively natural and intuitive way to distinguish among commodities, and shared characteristics plausibly signal something about substitutability. Additionally, characteristics-based rules are broad enough to admit development of new goods without requiring creation of novel taxes for each.

The counterfactual to most characteristic notches—a smoothly changing tax base definition—depends on the characteristic considered. Consider ‘When.’ The exact time of an event that triggers tax liability is continuous and generally knowable at relatively small cost. But under an annual system of accounting the date, other than the year, has no tax consequences, so having to keep track of that would be an added burden, as would

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<sup>32</sup> Blinder and Rosen (1985) do not, though, pose this question within a formal optimal taxation problem, nor would this be easy in their framework, in which there is no explicit reason to subsidize consumption of the ‘favored’ good, nor any other (eg Ramsey, 1927) reason to differentiate the tax on the two goods (there is no valued leisure in the individuals’ utility functions).

enforcing it.<sup>33</sup> Discrete accounting periods, generally annual, have many advantages. Daily income, as measured by current means, would be a highly variable measure of ability to pay. Even absent policy changes from year to year, however, the graduated income tax system provides incentives for cross-year movement of taxable income. The realization system plus deferral limited loss offset provides incentives for capital gains transactions at year-end, and there are rules to limit this kind of behavior.

Similar arguments apply to ‘Where.’ Precise location is cheaply knowable, but is not now an argument to tax liability functions. There are advantages to the decentralization of political and economic authority that are beyond the scope of this paper. Once in place, though, decentralization provides incentives for movement of economic activity across borders, including but not limited to local borders.

The hardest issue is ‘What,’ which arises in all tax systems. Although standard optimal tax theory prescribes it, it is practically infeasible to levy as many tax rates as there are separate goods. So it is natural to think of grouping goods that are close substitutes with each other. The infeasibility is even clearer when one considers that new goods are constantly being created. Occasionally what it is about a good that justifies tax differentiation is easily measurable and of low dimension: the Gas Guzzler Tax is an example. More common is the distinction in the US (and other) income tax systems between an employee and an independent contractor, which depends on a twenty-factor test where many of the factors are themselves difficult or impossible to measure. Over time regulations and rulings clarify what combinations of characteristics are on one side of the line, and which combinations are on the other. Once that becomes clear, bunching will follow.

Characteristic notches can also generate *tax-driven product innovation*, as new goods are created just on the low-tax side of the line.<sup>34</sup> In response, Kleven and Slemrod (2011) reformulate optimal commodity tax theory in the language of characteristics using the Gorman-Lancaster framework in which utility is derived from characteristics produced by goods, rather than the goods themselves. They establish that, the closer two goods are in characteristics space, the smaller the optimal tax rate differential. Secondly, the authors show how non-uniform tax systems may spur the creation of goods that are socially inferior (eg awkward car-like motorcycles), but that may be privately optimal for tax avoidance purposes. This represents a distortion in the set of available goods—a production inefficiency—distinct from the demand and supply distortions that typically concern public finance economists. Under certain assumptions on the production of new goods, the notches associated with line drawing create an incentive to bunch production and consumption of goods just on the low-tax side of a line that separates two tax rate regions. If feasible administratively, optimal lines should be drawn to avoid tax-driven product innovation completely. In a world with just two goods and two tax rates, this implies that the line should be ‘close enough’ to the characteristics of the low-tax good.

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<sup>33</sup> Even in an annual accounting system, dates of transaction may matter, for example to distinguish short-term from long-term holding periods for capital gains tax. The holding period distinctions are, of course, themselves examples of time notches. Thanks to Leandra Lederman for alerting me to this set of issues.

<sup>34</sup> Belan and Gauthier (2006) and Belan et al. (2008) investigate the optimal grouping of goods when only a limited number of commodity tax rates can be levied.

This result harkens back to the Diamond-Mirrlees production efficiency theorem, which acknowledges taxes are inevitably distortionary, but argues distortions in consumption behavior are welfare-preferred to distortions in production.

### 5.3 Other Justifications for Notch Use in Tax Design

It may be that notches get people's attention in ways that programs that feature smooth or kinked budget sets do not, so that they may be more effective in influencing behavior. It may be that they are more easily understood, an issue that is related but not identical to attracting attention. It is also possible that notches are widely misperceived, and so induce people to behave in ways that are not in their self-interest.<sup>35</sup> As of now these reactions to notches are a matter of speculation, as there is little evidence about the salience or related properties of notches, relative to either kinked or smooth policies.<sup>36</sup> Are, for example, most people more confused by a notch than by a series of kinks that approximate the notch? Is a system with continually adjusting marginal tax rates, thus requiring neither notches nor kinks, beyond anyone's comprehension? Apparently not, as since 2004 the German income tax system has featured continuously increasing marginal tax rates over certain income ranges. For example, in 2010, the marginal tax rate on income increased linearly from 14 to 24 per cent for those earning more than Euro 8 004 and less than Euro 13 469 (Federal Ministry of Finance, 2012). Tax economists have typically assumed that the administrative cost of such a system is prohibitive relative to one with a discrete number of marginal tax rates, but some speculate the high rate of electronic return filing through government-provided software eases the burden.<sup>37</sup>

To the extent that disputes arise about the arguments of the tax base, be they quantities or characteristics, notches limit the scope of these disputes to those in the neighborhood of the notch while raising the stakes to being on the wrong side of a notch.<sup>38</sup> In other words, the varying incentives created by notches result in a large infra-marginal segment and a small marginal segment. The latter group is strongly induced to respond, its incentives to relocate raised sharply by the existence of the line. This observation runs in parallel to the argument that notches create capricious<sup>39</sup> and widely varying local incentives. The cost of the adjudication system may vary across these dimensions.

## 6. CONCLUSIONS

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<sup>35</sup> Based on my personal observation, at least half of undergraduates beginning a public finance class believe that the kinks in the US income tax structure are in fact notches; after much discussion of this issue during the class, about a quarter of those completing the class do, too.

<sup>36</sup> It may also be that policy makers are subject to the same type of cognitive bounds in formulating policy.

<sup>37</sup> OECD (2012).

<sup>38</sup> Consider the adjudication costs of alternative class grading systems of 0-to-100 number grades versus (a small number of) letter grades. Under the former system all students have an incentive to complain, while in the latter only those near letter grade notches have the incentive to complain, but will do so more vigorously. Professors may have the incentive to not reveal who is close to a notch.

<sup>39</sup> I am presuming that the exact placement of a notch is usually arbitrary. That is certainly true for the case of the Gas Guzzler Tax (at .5 decimals of miles-per-gallon), but may not be true in all cases. Knowledge of local areas where response elasticities are relatively high would be a factor in the optimal placement of notches.

The ubiquity of tax policy notches calls for further inquiry into their consequences for behavior and their role in an optimal tax system. The taxonomy of notches proposed here is a first step. The demonstration of their welfare inferiority absent considerations of administrative cost or salience suggests that the latter issues warrant attention. While they persist, taxpayer behavior in the presence of notches has the potential to provide information about behavioral response, a task complicated by the need to separate out preferences and technologies on the one hand from mitigating salience factors on the other. Finally, the indisputable evidence about behavioral response to notches, unsullied by the need for arguable identification assumptions, puts to rest serious discussion of whether taxes matter. They do.

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# Designing tax policy: constraints and objectives in an open economy

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## **Abstract**

This paper is a non-technical discussion by an economist and lawyer, each with long international experience in taxation, of the constraints and objectives that in principle and practice shape tax policy design. After discussing the main factors traditionally taken into account by those charged with designing tax policy in any country – such as revenue, the costs of taxation, equity and fairness, administrability, and the effects of taxation on growth and other non-fiscal objectives – several additional important considerations associated with ‘globalization’ are then discussed with special attention to income taxes. The paper concludes with a brief reflection on how the ‘new world tax order’ in which countries must now develop their tax systems may perhaps develop over time.

## **INTRODUCTION**

Why do we have taxes? No one likes taxes. People do not like to pay them. Governments do not like to impose them. To spend, however, countries must tax. If they do not tax the long run consequences are likely to be even less welcome than taxation.<sup>2</sup> Taxes are necessary both to finance desired public spending and to ensure that the burden of paying for such spending is distributed in a way that is administratively feasible, economically sustainable and politically acceptable. Every country must thus have a tax system. But what tax system is best for any particular country at any particular time? The answer depends to a considerable extent on how much governments spend and what they spent it on.<sup>3</sup> Of course, since governments are really ‘us’ – the community or country -- in a different guise, when governments spend they are spending our collective resources and we, the citizens, are spending together,

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<sup>1</sup> The authors are respectively Professor Emeritus, Rotman School of Management, University of Toronto, Distinguished Visiting Professor, Andrew Young School of Public Policy, Georgia State University, and Visiting Professorial Fellow, Australian School of Business, University of New South Wales, and Partner, Blake Cassels & Graydon LLP, Toronto. An earlier and slightly different version of this paper, with even more of a Canadian focus, was commissioned by the Canadian Tax Foundation and appears as Chapter 2 in Kerr, McKenzie and Mintz (2012). In view of the mixed and relatively general nature of the audience of the original paper, we have endeavoured to keep both the economic and legal technicalities and references to a minimum.

<sup>2</sup> Countries can always print money to pay for public expenditures – the contemporary term is ‘quantitative easing’. But excessive or unnecessary recourse to this practice results in inflation which in itself in effect imposes an arbitrary, distorting and often highly unfair ‘tax’ on people. Formal taxes are a fairer and more efficient way to take purchasing power from people than inflating the currency.

<sup>3</sup> This paper does not consider the many factors that determine the appropriate (or actual) *level* of taxation at any particular time in any particular country but instead focuses on the question of how best to achieve any given level of taxation.

collectively. To put it another way, citizens through their political institutions may choose to consume collectively in the same way as households allocate the family budget.

Just as in a family, of course, not all are income earners so we may as a society may choose to share – redistribute – some of our collective revenues to ensure that those with smaller incomes are not excluded from such publicly-provided goods as education or health as well as to supplement their ability to obtain such privately-provided goods as food or shelter. Moreover, we may as a community also use the tax system to alter the risks and rewards associated with various choices that we as individuals may make with respect to how we spend our private incomes.

The larger the public sector, the more important it is to have as efficient, equitable and administrable a tax system as possible. What constitutes a good and feasible tax system for any country at any time depends on a host of primary social, political and economic considerations and choices. This paper considers both the objectives that a good tax system may attempt to achieve and some criteria that may guide not only the initial design and implementation of taxes but also subsequent adaptations to changes in domestic and international circumstances that may make the tax system less effective in achieving its objectives.

The nature of a country's tax system inevitably reflects both the relative weights that society through its political institutions decides to place on different objectives and the extent to which tax instruments are explicitly or implicitly intended to achieve those objectives. As an eminent American jurist (Oliver Wendell Holmes) once said, taxes are the price we pay for civilization. It is not surprising, then, that many of the criteria commonly associated with identifying and devising good tax policy reflect notions of 'fairness' -- sometimes considered the glue of a democratic society -- in the distribution of tax responsibilities. The collective consumption effected through taxation both facilitates civil society and establishes its boundaries. Private opportunities for benefit and gain to a substantial extent depend on the existence of a civil society that permits and encourages people to be engaged in a variety of social, political and economic relations so long as their activities do not cause harm to others. A sustainable well-functioning modern society requires a population that is both physically and intellectually well-nourished. In the modern world, private and material economic success thus needs and depends on good legal, medical, education and public safety systems. Since we all benefit from such systems presumably 'fairness' demands that we should all contribute to their support to some extent. But what is a fair way to do so?

Two distinct fairness 'principles' are commonly employed to assess tax policies. One is the *ability to pay principle* -- that those who can pay more should pay more. The other is the *benefit principle* -- that those who benefit most should contribute most. Although good arguments can be made in terms of both equity and efficiency that the benefit principle should be applied whenever possible, it cannot easily be applied to financing most of the expenditures of governments.<sup>4</sup> It is thus some version of the ability principle, broadly conceived, that most consider relevant when it comes to the design of such broad-based taxes as income and sales taxes.

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<sup>4</sup> The scope for such taxation (and charging) tends to be much greater with respect to local as compared to national government as discussed, for example, in Bird (2001).

Whatever one thinks of redistributive taxation, common sense – as well as good economics -- suggests that the ‘price’ of taxation – the costs of the tax system -- should be kept to a minimum. In order to achieve this goal the tax system must work properly in the sense that the taxes imposed can actually be collected in an observably accurate and accountable way. A second requirement is that people should be as fully aware as possible of what they are paying -- and of what they are getting in terms of both direct personal benefits as well as from more general collective consumption decisions including those that use the tax system to encourage and discourage certain activities.

Section 1 of this paper focuses on such key policy objectives of taxation as revenue generation and distribution and the achievement of non-fiscal policy objectives (such as economic growth and industrial policy). This section also discusses the traditional trinity of tax policy criteria -- equity, efficiency, and administrability. *Equity*, for example, is often divided into two subcategories – *horizontal equity* (the principle that those who are equal should be treated equally by the tax system) and the related but distinct concept of *vertical equity* (the principle that those who are unequal with respect to some relevant characteristic such as income or disability should be treated appropriately unequally by the tax system). Both aspects of equity may or may not be included in the more general notion of fairness mentioned earlier.

As the priority that many attach to equity issues in appraising tax policy suggests, tax policy is by no means just about economics. Inevitably, it also reflects political factors, including concerns about fairness in the sense of the distribution of income, wealth and consumption. Taxes may affect distribution through changing economic incentives as well as by being more or less *progressive*, that is, increasing more than proportionately with respect to the amount of income accruing to particular individuals or families – assuming that is the basis on which comparisons are made.<sup>5</sup> In addition to affecting the distribution of income, wealth, and consumption, taxes almost always impose real costs on society. These costs include not only the obvious *administrative costs* shown in government budgets but also the less obvious *compliance costs* imposed on taxpayers and, even more importantly, the equally real, but largely invisible, *efficiency costs* that are imposed on society as a whole when economic decisions are altered as a result of taxation. Broadly understood, an efficient tax policy is one that keeps the sum of all these costs to a minimum while achieving other tax policy objectives to the extent possible. Finally, regardless of the objectives or goals that any country may wish to accomplish through tax policy, in practice what tax policy accomplishes depends on whether it is administered effectively. *Administrability*, like efficiency and equity, is thus invariably a key criterion that needs to be considered in designing and evaluating tax systems. All this is discussed further in Section 1.

However, the discussion in Section 1 does not go as far as is necessary to cope with some latent, but increasingly evident, forces that now impinge on tax systems everywhere. For the most part, Section 1 follows the traditional path of implicitly assuming that a country can exist in isolation from the rest of the world. In reality, none ever has and none ever will. Good tax policy must therefore take explicitly into account the international setting. Countries cannot, and should not, consider and pursue policy objectives and decisions in isolation. The new demands made on tax policy by international factors suggest a somewhat new framework for guiding tax policy analysis

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<sup>5</sup> At a deeper level, as the new fiscal sociology suggests, the perceived fairness of the tax system may also play a critical role in ensuring the long-run sustainability of political and state institutions: see, for example, Brautigam, Fjeldstad and Moore (2007). However, we do not pursue this point further here.

may be needed, as discussed in Section 2 of this paper. Though much of the contemporary discussion about the need to take international factors explicitly into consideration in designing and developing tax policy has focused on business taxation, the implications are deeper. How businesses (including the legal fictions called corporations) are taxed affects all citizens in one way or other. Taxes are, in the end, always and everywhere paid not by legal entities but by people, whether directly on wages and investment income or explicitly or indirectly on purchases of goods and services. A well-known comic strip (Pogo) once said: 'We have seen the enemy and they is us.' We may or may not want to do what others do, but there is no doubt that our choices must contend with the reality that they have done it, or may do it soon. Section 2 develops some possible implications for tax policy objectives and design arising from the need to accommodate the reality in most countries of increasing integration into the world when making national tax policy.

By reducing the degrees of freedom available to policy designers at the national level, globalization has in some ways shifted the terms of national tax policy discussion in many countries closer to the 'model' commonly set out for tax policy design at the subnational level. This is not an unfamiliar situation for those living in federal countries like Canada, Australia or the United States since in such countries tax infrastructure is in some respects an international tax system in microcosm – a constellation of tax satellites, the provinces or states (and local governments) operating within the gravitational field of a central tax sun, the federal regime. The concluding Section 3 of this paper therefore considers briefly whether there are any lessons to be found in subnational experience for national tax policy in an evolving world of international tax forces, experiences and influences that affect all countries to varying degrees, but with none being uniquely accountable or in a controlling position.

## **1. THE TRADITIONAL APPROACH**

### **1.1 Introduction**

Most discussions of tax policy objectives in any country begin by stating that the fundamental objective of taxation is to secure the resources needed for public sector purposes in an equitable, efficient and sustainable fashion and then proceed to set out a series of criteria that may be used to evaluate the suitability of different tax instruments to achieve this basic aim. In reality, of course, in the end tax policy is often determined largely by political factors (such as the federal nature of a country), but in this section we follow this general tradition, considering the design of an appropriate tax system largely in economic and administrative terms (other than the discussion of the critical equity issue), essentially in isolation from other policies, and largely without paying attention to the international context.

### **1.2 Revenue**

#### ***1.2.1 Reliable revenue flows***

To begin at the beginning, the most basic and essential characteristic of a good tax system is that it raises sufficient revenue to fund government operations and programs. The rate at which revenues increase over time depends on the tax structure, the quality of tax administration, and the pace and nature of economic growth. The income elasticity of a tax system measures how fast revenues grow relative to the economy. Tax elasticity is defined as the percentage change in tax revenues divided by the

percentage change in GDP (or potential tax base, such as personal income). Elasticity equal to one, for example, means that tax revenues will remain a constant share of GDP. Elasticity greater than one indicates that tax revenues grow more rapidly than income. In principle, over time revenues should on average grow at about the same rate as desired expenditures (that is, the income-elasticity for revenues and expenditures should be the same). As an example, over the 1970-90 period the buoyancy of general government receipts (including both taxes and non-tax receipts) in Canada was 1.2, compared to only 0.9 for the 1990-2008 period; interestingly, since the buoyancy of total government expenditures was 1.4 in the first period and 0.9 in the second period, the tax system has done a better job in terms of financing public expenditures in recent years.<sup>6</sup>

### ***1.2.2 Effects of Tax System Structure***

The overall elasticity of any tax system is simply the average of the elasticity of individual taxes, weighted by the percentage of total taxes raised by the tax. The elasticity of a tax depends on the specific characteristics of its structure. The elasticity of personal income taxes generally reflects the progressivity of their rate structure and, most importantly, the level of the personal exemptions (or zero bracket) relative to average income levels. Consumption taxes are more elastic if they cover more rapidly growing goods and services rather than just more slowly growing traditional goods (such as the traditional 'excise' goods of tobacco and alcohol) and if they are levied as a percentage of the price (like the GST) rather than on the specific quantity purchased (as with most tobacco and fuel taxes). Property tax revenue increases more rapidly when reappraisals occur on a regular basis and when property is fully and regularly valued.

### ***1.2.3 Revenue growth***

Revenue growth generally slows during recessions and accelerates during expansions. Revenue elasticity also tends to rise in expansions and fall in recessions, thus exacerbating the volatility of revenue flows. The corporate income tax is particularly volatile because in a recession corporate profits decline more rapidly than overall economic growth. Countries that depend heavily on taxation of natural resources such as oil or minerals are especially vulnerable to cyclical swings, with wide swings in commodity prices changing the level of tax revenues. Generally, a country that relies on a balanced set of tax instruments rather than a single revenue source will have lower tax revenue volatility, just as an individual investor can reduce the volatility of her investment portfolio by adopting a diversified investment strategy.

Of course, there is much more to tax policy than revenue and more to measuring its significance than such simple analytical parameters as elasticity. One reason this is true is simply because the economy inevitably extends beyond national borders. For example, a recent official Canadian report argued that '...the goal for Canada should be to make this country the location of choice for the higher-value elements of ... global value chains – whether led by Canadian firms or as part of others' supply chains – as higher-value productive activity translates into higher wages and salaries., more

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<sup>6</sup> Calculated from data in Department of Finance (2010). Tax 'elasticity' refers to revenue growth in the absence of any tax policy changes, while tax 'buoyancy' refers to growth including the effects of such changes. In principle, elasticity is a better measure of the growth potential of an existing tax structure; however, buoyancy is both easier to estimate and in some ways more relevant in showing the extent to which countries finance public expenditures through taxes.



occupational choice and a better quality of life for Canadians’ (Government of Canada (2007, 6). What this means among other things, as the same panel’s final report said, is that ‘tax policy involves more than deciding how much revenue must be raised. An equally important policy issue is the design of a scheme of taxation and its impact on individual and corporate incentives and behaviour....’ (Government of Canada (2008), 62). Of course, similar concerns are important even in a solely domestic context.

### 1.3 The Costs of Taxation

#### 1.3.1 Administrative Costs

Taxes are essentially a means of transferring resources from private to public use (or possibly from self-selected private uses to collective private uses as determined and organized through public intervention for which tax policy as a tool). Taxation in principle need not affect the amount of resources available for society’s use, whether for public or private purposes. However, few if any taxes come free. Most obviously, taxes cost something to collect. These administrative costs are not excessive in most developed countries – in Canada, for example, they are a bit more than 1 percent of tax revenues<sup>7</sup> – but they are obviously real costs, in the sense that they reduce the revenues available for other public policy purposes.

#### 1.3.2 Compliance Costs

Equally obvious to taxpayers, though not recorded in the government budget, are the compliance costs that taxpayers incur in meeting their tax obligations, over and above the actual payment of tax. Tax administration costs may sometimes be reduced by increasing compliance costs – as when taxpayers are required to provide more information in order to make tax administration easier and less costly. In other instances, however, both compliance costs and administration costs may increase if, for instance, a more sophisticated tax administration requires more information from taxpayers and then undertakes more audits on the basis of this information. Third parties also incur compliance costs. For example, employers withhold income taxes from employees, and banks provide taxing authorities information or may collect and remit taxes to government. Compliance costs include the financial and time costs of complying with the tax law, such as acquiring the knowledge and information needed to do so, setting up required accounting systems, obtaining and transmitting the required data, and payments to professional advisors. Although the measurement of such costs is still in its infancy, Canadian studies suggest that compliance costs are probably at least four to five times larger than direct administrative costs.<sup>8</sup> In particular, the evidence shows that compliance costs are relatively a much greater burden on smaller than on larger firms.

#### 1.3.3 Efficiency Costs of Tax-Induced Decisions

In addition to administrative and compliance costs, taxes generally impose real economic costs (often called *deadweight losses* or *excess burdens*) which reduce the

<sup>7</sup> On average over the 2001-2007 period, the administrative costs of the Canada Revenue Agency were 1.2% of revenue collected (calculated from data in OECD (2009)). Canada’s direct administrative costs for taxation tend to be higher than those in the United States largely because a substantial part of Canada’s income support system is operated through the tax system (as discussed in Kerr, McKenzie and Mintz 2012).

<sup>8</sup> A recent study estimates that compliance costs in Canada are between 4 and 6 times greater than administrative costs: see Vaillancourt, Clemens, and Palacios (2008).

total resources available for public and private purposes. These ‘distortion costs’; arise essentially because most taxes alter the decisions made by businesses and individuals because the imposition of the tax changes the relative prices they confront. There are a few exceptions. Lump-sum taxes, where the tax burden is the same regardless of any behavioural responses by taxpayers, are often used to provide a base-line case in tax analysis although such taxes seldom exist in practice. More practically important is the fact that to the extent that taxes fall on economic ‘rents’ – payments to factors above those needed to induce them into the activity concerned – they too may not affect economic activity. Well-designed taxes on natural resources and land, for example, may thus to some extent produce revenue without economic distortion. Finally, in certain instances, taxes – again, if properly designed – may actually change economic behaviour in a way that improves well-being, of the person concerned, of the community as a whole, or both. Certain environmental levies, for example, or even crude proxies such as taxes on fuel, may to some extent have such effects.

Such instances of good taxes – those with no bad economic effects – should of course be exploited as fully as possible; similarly, well-designed user charges should be used to the extent possible, given public policy objectives, to finance certain public sector activities that specifically benefit identifiable individuals. In the end, however, most taxes needed to finance government inevitably give rise to changes in behaviour that, it is usually assumed, reduce the efficiency with which resources are used and hence lower the output and potential well-being of the country as a whole. No matter how well the government uses the resources acquired through taxation, everyone loses from the negative consequences of tax-induced changes in behaviour, so one concern in designing tax policy is to limit such efficiency losses.

For example, taxes on wages (personal income taxes, payroll taxes) obviously reduce incentives to work by reducing the amount of income people receive for giving up a certain amount of leisure (non-working) time. Consumption taxes like the value-added tax and retail sales taxes similarly may discourage work by increasing the amount of time one must work to pay for goods and services through the marketplace. Taxes on both wages and consumption thus alter both relative prices (in this case, the net - after-tax - wage) and income. However, people may choose to work more to compensate for lost income. The net effect on work of any tax change reflects both this *income effect* and the effect of the change in relative prices (the *substitution effect*). Although the evidence is not all that strong, on the whole taxes do seem clearly have some effect on work decisions, with the precise strength and nature of the effects depending upon the structure of taxes, the nature of the workforce, and the changing economic context. In particular, the substitution effect (the change in the relative reward for working) creates distortions by causing people to change such work-related decisions as when to enter the labour force, how much education to attain, what career to pursue, how long and hard to work, and when to retire. If those decisions were economically efficient before the tax, the effect of such tax-induced distortions – their efficiency cost -- is to reduce the potential output of the nation.

Taxation may similarly affect other economic decisions. General consumption or sales taxes may discourage the consumption of taxed as opposed to untaxed goods. Excises on fuel, alcohol, and cigarettes can reduce the consumption of these items.<sup>9</sup> Income taxes, because they tax the return to savings, may alter the amount of savings or the

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<sup>9</sup> As noted earlier, not all such effects need be bad: for instance, if tobacco consumption is reduced, people may live longer, healthier and more productive lives.

form in which savings are held. For example, failure to tax capital gains until they are realized (when the asset is sold) encourages the holding of assets (a lock-in effect). Taxes may also affect investment, and such effects may be especially important when economies are more open to trade and investment. Foreign investors may choose to locate their activities in a particular country for many reasons such as the relative costs of production, access to markets, and sound infrastructure but taxes too may influence their choice of location. To the extent taxes lower the after-tax return on investments in a country or a region, the level of investment and hence growth may be lower than it would otherwise be. Corporate income taxes may also influence the composition of a firm's capital structure (use of debt or equity financing) or dividend policy. For example, retained earnings are encouraged when dividends are subject to tax at the shareholder level and debt is preferred over equity where interest on debt capital is deductible and dividends paid from equity capital are not.

### ***1.3.4 Tax Effects and Economic Choices***

Exactly how important such tax effects are is a matter of considerable debate, but the consensus is that they are much more important than was thought thirty or forty years ago and that the efficiency costs of taxation are a considerable multiple of the administrative and compliance costs mentioned above. About a decade ago, for instance, the Canadian Department of Finance estimated the marginal efficiency cost – the estimated loss in national welfare as a result of increasing taxes by \$1 – of the corporate income tax (CIT) as \$1.55, compared to only \$0.56 for the personal income tax (PIT), \$0.27 for payroll taxes (like those financing the public pension plan) and \$0.17 for the GST, Canada's national consumption tax.<sup>10</sup> Given the composition of tax revenues in Canada, these figures suggest that the efficiency costs of the existing tax system are much greater than the combined administrative and compliance costs of taxation, with taxes like CIT that affect intertemporal decisions – saving and investment – being particularly costly in these terms.

If one is prepared to assume that the efficiency costs of taxation result from conscious policy decisions (for example, to redistribute income through the fiscal system), the price may be worth paying. Unfortunately, however, it is all too easy to underestimate the damage done by inefficient taxes. Although efficiency losses are definitely real, they are not directly visible. The efficiency cost of taxation arises because something does not happen: some activity did not occur or occurred in some other form. Although achieving a more economically efficient tax system would make Canada as a whole better off, doing so is unlikely to be either a politically popular or readily understandable policy aim since these 'hidden costs' can only be estimated through rather complex and hard-to-understand economic models. Output that is not produced, however, is still output lost, and since there is no conceivably acceptable rationale for inflicting pain without gain, an important and sensible tax policy objective for tax policy designers always and everywhere is to attempt to minimize the efficiency losses from taxation to the extent other policy considerations permit.

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<sup>10</sup> As reported in OECD (1997). More recent detailed analysis generally yields similar rankings (Bibbee 2008).

### 1.3.5 Taking account of tax costs

To minimize imposing unnecessary costs through taxation, experience suggests three general rules should be followed.

#### *Tax Base Breadth*

First, tax bases should be as broad as possible. A broad-based consumption tax, for example, will still discourage work effort but at least such a tax reduces distortions in consumption by taxing a broader range of goods and services uniformly.<sup>11</sup> A more broadly-based consumption tax like a value-added tax that encompasses a wide range of services is thus more efficient than most retail sales taxes like those levied by US states, which exclude many services and tax many ‘investment’ goods (such as computers and other office equipment), essentially because the former is less likely to distort consumption (and investment) decisions. A few items, such as fuel, tobacco products and alcohol, may be taxed at a relatively higher rate – for administrative simplicity, preferably a rate imposed through separate excise taxes -- either because of regulatory reasons or because the demand for these products is relatively unresponsive to taxation. Finally, for similar reasons, in principle the tax base for income tax should also be as broad as possible, treating all income, no matter from what source, as uniformly as possible.<sup>12</sup>

#### *Tax Rates and Rate Induced Distortions*

Second, tax rates should be set as low as possible, given revenue needs. The reason is simply because the efficiency cost of taxes arises from their effect on relative prices, and the size of this effect is directly related to the tax rate. The distortionary effect of taxes generally increases proportionally to the square of the tax rate, so that (other things being equal) doubling the rate of a tax implies a fourfold increase in its efficiency costs. From an efficiency perspective, it is thus better to raise revenue by imposing a single rate on a broad base rather than dividing that base into segments and imposing differential rates on each segment. Of course, any efficiency costs arising from differential treatment need to be balanced against the equity arguments noted below for imposing graduated rate schedules.

#### *Location Effects*

Third, from an efficiency perspective, it is especially important that careful attention be given to taxes on production. Taxes on production affect the location of businesses, alter the ways in which production takes place, change the forms in which business is conducted, and so forth. This is one of the main reasons that value-added taxes (VATs) are superior to other forms of general consumption tax as well as to import tariffs and most selective excise taxes. This dictum also implies that taxing corporate income is

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<sup>11</sup> In theory, in order to minimize efficiency losses different tax rates should be imposed on each commodity, with higher rates imposed on those goods and services where the changes in behaviour are the smallest as well as on those that are complementary to leisure (in order to reduce the negative impact of taxation on work decisions by in effect imposing some taxation on ‘non-work’ or leisure). To do so, however, requires much more information about how taxes alter behaviour than is available in most countries. Moreover, this approach does not take administrative and equity concerns into account. In general, expert consensus is thus that in practice it is probably generally advisable to impose a uniform tax rate to the extent possible. (For a good discussion of this issue, see Crawford, Keen and Smith 2010.)

<sup>12</sup> As Section 2 below suggests, however, consideration of the ‘open economy’ nature of many countries casts some doubt on this conclusion.

unlikely to be a good idea. On the other hand, some form of taxation on corporate income is generally considered essential both to prevent tax avoidance by those who own corporations and to collect taxes from foreign-owned firms. The appropriate design of corporate income taxation is thus a particularly difficult task, not least because of the changing reality of the international context we discuss in Section 2 below.

## **1.4 Equity and Fairness**

Fairness or equity is a key issue in designing a tax regime. Indeed, from one perspective, taxes exist primarily to secure equity. National governments do not need taxes to secure funds because they can simply print the money they need. Indeed, the tax system can be seen in essence as a mechanism for taking control of resources away from the private sector in as efficient, equitable, and administratively effective way as possible, in order to redirect them to serve public objectives that would otherwise be unattainable.

### ***1.4.1 Structural Equity***

What is considered equitable or fair by one person may differ from the conceptions held by others. Traditionally, as already mentioned, fairness has been understood in the tax context in terms of horizontal and vertical equity. Horizontal equity requires those in similar circumstances to pay the same amount of taxes. Vertical equity requires appropriate differences among taxpayers in different economic circumstances. Equity in both these senses often embraces some notion of ability or capacity to pay. Such concepts have intuitive appeal but are of very limited usefulness when it comes to determining tax policy. These traditional equity concepts do not determine or even provide a useful substantive guide to what good tax policy is; nor do they allow us to characterize decisions that seem to deviate from these concepts to be ‘bad’ tax policy.<sup>13</sup> At most, they perhaps serve as a point of reference for measuring the effects of choices that in one way or another appear to deviate from these concepts.

### ***1.4.2 Fairness and tax burden***

Consider several possible conceptions of fairness. To some, fairness may require everyone to pay the same amount of tax. For example, the tax system might impose a head tax on each individual over the age of 18 years old. Or, more plausibly, one might perhaps require all taxpayers to pay the same rate of tax on their income. To others, however, fairness requires those taxpayers with higher income to pay a higher percentage of their income in tax. Although a progressive rate structure has a rather shaky theoretical foundation, it has been the most common income tax rate structure. Many find assessing progressive taxes on income (as measure of ability to pay) attractive simply on the grounds that the rich are better able to contribute to the financing government.

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<sup>13</sup> For example, to make the concept of horizontal equity useful one must determine which differences are important and why these differences justify different tax treatment. Unless people have identical tastes and a single type of ability or income, it is difficult to derive any clear policy implications from this concept. One must also decide whether to focus only on a short time period, such as one year, or take a longer, lifetime perspective. Similarly, it matters whether one takes into account the impact of other taxes and the provision of government services or other benefits. Even more disagreement exists about the usefulness of the concept of vertical equity and about what constitutes appropriate differences in treatment.

### ***1.4.3 Fairness and the choice of tax bases***

On the other hand, consumption tax proponents question whether any income tax system can be fair. One approach takes a societal view. Income is what individuals contribute to society; consumption is what they take away from the pot. Therefore, if we want a society that will continue to grow and prosper, we are better off taxing consumption rather than income. A second approach considers consumption as a better measure of a household's ability to pay. Because income varies more than consumption over a person's or household's lifetime, some argue that it may be better to use consumption as the base for taxation rather than income. Finally, since income taxes impose higher taxes on households with higher savings, the income tax penalizes savers over those who consume currently.

On the other hand, income tax proponents claim that a person's net increase in economic wealth is a better measurement of ability to pay than the use of their income. Someone who earns \$1 million and spends \$10 has a greater ability to pay someone who (in the same time period) earns \$10 and spends \$10. Under a consumption tax, both would bear the same tax burden while under an income tax the first person would bear a much greater tax burden. Of course, this is only a two-period example, which assumes that a year is the right period in which to assess the relative tax status of different people. If one thinks that most people go out of this world as they come into it – with no worldly goods – by definition their income and consumption are equal from a lifetime perspective. Many issues – such as the regressivity or progressivity of different taxes – may thus look very different depending upon the time period that is considered relevant for purposes of assessing tax fairness.<sup>14</sup>

### ***1.4.4 Fairness and over-riding political, social and economic policy***

The previous comments suggest that discussions of fairness in general or of horizontal and vertical equity in particular, are of limited usefulness. Without first specifying a fundamental ethical framework one cannot evaluate the relative fairness of different proposals or different tax regimes. Moreover, even if one sets out such a framework, and is prepared to assert that everyone else should accept it also, it does not follow that they will do so. In the end, it is thus only through its political institutions that any country can really define and implement a view of what is an acceptably fair tax system. One may not like what politicians do, but what they do is what, whether we realize it or not, we have at some fundamental level chosen to do as a society. Of course, policy choices may also be affected by various collateral influences on the need for and effectiveness of government policy, including influences exogenous to the national economy such as those we address under the label of 'globalization' in Sections 2 and 3 below.

In any event, rather than discussing, interminably, such inherently controversial philosophical questions as equity it might be best to focus directly on the expected consequences of different policy choices. Both the intended and the effective impacts of policy are often hard to determine with any certainty. Nonetheless, answers may perhaps be obtained to some factual questions. The same cannot be said about policy debates reflecting different philosophical (or ideological) beliefs – unless one is, as suggested above, prepared to accept whatever emerges from a country's political

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<sup>14</sup> For a discussion of how sensitive studies of tax incidence in Canada (as elsewhere) are to assumptions about the relevant time period and many other arguable aspects, see Kesselman and Cheung (2004).

institutions as having resolved all such debates! In the practical policy world if, from the perspective of social and economic inequality, what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income then both expenditures and taxes should be taken into account. Taxes affect equity in many and complex ways, and different citizens may view many of these consequences differently. Some may wish to favour cities and those who live in them, for selfish or developmental reasons; for similar interested or disinterested reasons, others may wish to favour farmers and those who live in rural areas. Similarly, some may wish to favour rich savers in the name of growth and others the poor in the name of fairness and redistribution. However, since presumably all are ultimately interested in outcomes, good tax policy should be based as much as possible on evidence-based research into consequences rather than faith-based presuppositions. Equally, there is much to be said for ensuring that the debate on both evidence and philosophy should be as inclusive as possible and that due attention is paid to ensuring procedural equity through as open, transparent and comprehensive a policy process as possible.

#### ***1.4.5 Distributional effects and goals***

Like most policy instruments, tax policy can play many tunes. What is critical from an equity perspective is, first, to be as aware as possible of the distributional implications of tax changes not only for income distribution in general but also for the different groups that are evidently of policy concern in most countries -- the old, homeowners, children, the poor, people in depressed regions, etc. -- and, second, to ensure that the actual outcome of such reforms is as consistent as possible with the intended outcome. For instance, although taxes cannot make the poor richer, they may certainly make them even poorer, in both absolute and relative terms. Since it is hard to conceive of any socially desirable reason to adopt increased poverty as a policy goal, heavy taxes on items that constitute major consumption expenditures for poor people should generally be avoided. There are two caveats to this conclusion, however. First, in some instances there may be an overwhelming social argument for even quite regressive taxes, as many think there is with respect to tobacco taxes, for example. Second, if regressive taxes provide a significantly less costly source of revenue, as the data cited earlier on the marginal efficiency costs of different forms of taxation imply, and any undesirable distributional effects of such taxes can be offset by direct expenditures or adjustments elsewhere in the tax system (such as income tax credits), such taxes may have an important role to play in the tax system as a whole.<sup>15</sup>

On the other hand, taxation is one of the few ways short of outright confiscation in which the wealthy may be made less wealthy. Although the evidence seems to be that taxes have had at best only moderate success in reducing income inequality in developed countries and that those countries that have more effective redistributive policies have implemented them mainly through more progressive expenditure policies,<sup>16</sup> some degree of explicitly redistributive taxation might nonetheless be considered to be

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<sup>15</sup> As noted earlier, Canada uses the income tax system extensively to provide income support to certain low-income people. While important, the potential use of tax policy as the basis for a more efficient and equitable transfer policy is not discussed further here.

<sup>16</sup> For example, the study of incidence in Canada by Kesselman and Cheung (2004) concludes that, despite the wide variety of outcomes that are conceptually possible within the framework of empirical incidence studies, under most 'reasonable' assumptions taxes are progressive, if at all, only with respect to the top decile of taxpayers, and transfers are much more important in terms of reducing inequality.

socially or politically essential as one component of maintaining and sustaining the state. On the other hand, if the major concern is to help those who most need help, that objective is much more likely to be achieved through expenditure than tax policy, and the policy balance may shift from progressive to more proportional means of financing redistributive expenditures, as is generally the case in the ‘social welfare’ countries of northern Europe.<sup>17</sup>

#### **1.4.6 Incidence – Who Pays?**

Turning back to economics, in order to determine the fairness of a tax regime, one must also consider carefully who ‘really’ pays taxes – what economists call the ‘incidence’ of taxation. The person or entity required by law to pay a tax need not be the one whose economic well-being is reduced by the imposition of the tax. In the end taxes always ‘burden’ or fall on individuals in their roles as consumers, producers and factor (labour, capital) suppliers and not on corporations or other institutional abstractions. For example, although the VAT requires firms to pay VAT on their sales, it is both expected and likely true that the real economic incidence of the tax falls on the ultimate consumer. Similarly, although motor fuel taxes are in practice collected from distributors in most countries, the full burden of such taxes is usually considered to be borne by consumers just as the full burden of the personal income tax is usually assumed to be borne by the person who pays it. In all these cases, however, these are at best plausible assumptions rather than empirically-based facts. In other instances, even plausible assumptions about who actually bears the economic costs of taxation are hard to find. For example, property taxes may be ultimately paid (in the sense of reducing the income of) either owners of land and capital (who also bear the legal incidence) or by the users or renters of the property, depending upon market conditions. Asking for a definitive answer about which groups, let alone individuals, pay the property tax is like asking for certainty about which team will win the league championship in any year.

Who pays the corporate income tax is even more difficult to assert with any confidence, especially in an open economy such as Canada – and, to some extent, most countries.<sup>18</sup> Corporations are in essence simply legal constructs. Taxes imposed on corporations ultimately must fall on individuals: but which individuals? Conceptually, corporate income taxes may lead to shareholders (or, perhaps even the owners of all forms of capital, including houses and pensions) receiving lower returns. Or they may result in consumers paying higher prices, or workers receiving lower wages, or any conceivable combination of these outcomes. In addition, the immediate impact of a tax in the short

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<sup>17</sup> A useful discussion of the role tax policy plays in these countries may be found in Lindert (2004).

<sup>18</sup> Although this point is not strictly relevant to the incidence issue discussed in the text, we should note that, unlike the case in the United States, Canada’s corporate income tax is ‘integrated’ to a considerable extent with the personal income tax for Canadian residents. Nonetheless, Canada, like most countries, continues to impose some corporate income tax that is not offset by credits at the individual level. Although we also do not discuss here other possible rationales for corporate taxation as a means of taxing economic ‘rents’ and income accruing to foreign residents, it is worth noting a recent argument that the corporate income tax is an important part of the tax system primarily because it can (and does) serve as an important regulatory instrument (Avi-Yonath 2011). In this ‘one tax-one goal’ view, the main objective in designing general consumption taxes is to obtain revenue in the least costly way possible, the main objective with respect to designing personal income taxes is to achieve the socially desired amount of redistribution through the tax system, and the main objective in designing corporate income taxes is to influence large businesses to make decisions in line with public policy objectives.



run may differ substantially from its incidence in different macroeconomic (cyclical) conditions as well as from its long-run incidence after all market adjustments take place. The incidence of a corporate income tax thus depends on such complex matters as the openness of the overall economy in terms of the inflows and outflows of capital investment, the extent to which capital moves between the corporate and unincorporated sectors, the relative capital-intensity of corporations, and the elasticity of demand for goods produced by corporations and other businesses. Such factors and the relations between them are not easy to measure and the outcomes of particular tax policy changes in this area are inherently difficult to understand -- and hence perhaps especially likely to be based on assumptions rather than evidence.

Other considerations add to the difficulty of trying to determine the tax burden of both individuals and groups of individuals in different income classes. For example, the more taxes that there are, the more difficult it becomes to untangle the incidence of any particular tax change from the cumulative and interactive effects of the total group of taxes. Moreover, a complete analysis of incidence requires consideration of all parts of government activities including both government expenditure programs and regulatory policies. For example, a complete analysis of the incidence of payroll taxes levied to finance pensions requires estimates not only of the incidence of the tax but also of the retirement benefits provided. All in all, when it comes to the distributional impact of most tax changes we are generally operating even more in a world of assumption and conjecture than is the case with respect to the efficiency aspects of taxation.

## **1.5 Administrability**

Since the best tax policy in the world is worth little if it cannot be implemented effectively, tax policy design must also take into account the administrative dimension of taxation. What *can* be done may to a considerable extent determine what *is* done. This factor shapes tax policy in particular in the international sphere, as discussed further below. More generally, as already mentioned, the resources used in administering and complying with taxes (or, for that matter, evading them) are real economic costs that diminish the ability of the economy to provide goods and services. Good tax policy requires keeping such costs as low as possible while also achieving such objectives as revenue, growth, and redistribution as effectively as possible. This is no small task.

### **1.5.1 System design**

Three ingredients seem essential to effective tax administration: the political will to administer the tax system effectively, a clear strategy for achieving this goal and adequate resources for the task. It helps, of course, if the tax system is well designed, appropriate for the country, and relatively simple, but even the best designed tax system cannot be properly implemented unless these three conditions are fulfilled. Most attention is often paid to the resource problem - the need to have sufficient trained officials, adequate information technology and so on. However, without a sound implementation strategy, even adequate resources will not ensure success. And without sufficient political support, even the best strategy cannot be effectively implemented.

### **1.5.2 Collecting information and tax**

Effective tax administration requires not only qualified tax officials but also, in largely 'self-enforced' systems like those in Canada and the United States, a good deal of

information supplied by taxpayers and related third parties such as banks, other businesses, and tax practitioners, particularly accountants. Tax officials must be able to know about and collect the information needed for effective administration from taxpayers, relevant third parties, and other government agencies, all of whom need to comply with their reporting responsibilities. The administration must store all this information in an accessible and useful fashion. And, most importantly, it must use the information to ensure that those who should be on the tax rolls, are, that those who should file returns, do, that those who should pay on time, do, and that those who do not comply are identified, prosecuted and punished as appropriate. All this is easy to say but hard to do. However, the task is not impossible and for the most part tax administrators in most developed countries manage to do a relatively good job.

As we discuss further in Section 2, however, globalization confronts tax administrations with new and difficult problems. For example, tax administrations must ensure that revenues and expenses occurring in other countries are properly calculated in determining taxable profits for the corporate income tax, and that export credits and refunds are properly handled under VATs like Canada's GST/HST. Enforcing a tax system is neither an easy nor a static task in any country. It is especially difficult in an open economy with many cross-border transactions and in rapidly changing economic conditions like those in recent decades. Unless this task is tackled with seriousness and consistency, however, even the best designed tax system will fail to produce good results.

## 1.6 Taxation and Growth

### 1.6.1 *Is there a connection?*

Growth is seen by many as an objective that tax policy should accommodate. Although much has been written and said about the effects of taxation on growth, there is still much we do not understand about this complex subject.<sup>19</sup> Consider, for example, the trade-off between growth and equity. Most people would like to be richer. Many may also want the increased wealth to be distributed fairly. Are these objectives compatible? As mentioned earlier, collective action through the fiscal system presumably to some extent makes us better off both as a community and as individual citizens. However, many may be less aware of the public benefits than of the private costs of giving up control over some of their resources to the government. Measuring public interests through the lens of private interest obviously distorts perceptions of what is good tax policy. For this and other reasons, although many theoretical and empirical explorations have been made of the potential growth-equity trade-off, no simple or definitive answer to this key question is possible.

What seems clearer, however, is that there is no magic tax strategy to encourage economic growth. Some countries with high tax burdens have high growth rates and some countries with low tax burdens have low growth rates. Looking at the relationship between growth rates and tax rates in Canada over the last 50 years shows, for example, that Canada has had some of its periods of fastest economic growth during those years where the tax rates were the highest.<sup>20</sup> Of course, this does not in any way imply that

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<sup>19</sup> A useful review of the complex tax-growth relationship may be found in Johansson et al. (2008).

<sup>20</sup> The year to year or even decade to decade relationship between growth rates and tax ratios is not particularly strong, but to illustrate the point made in the text consider two extreme cases, the 1960s when

high tax rates are the key to economic growth. It may be that growth rates in Canada would have been even higher in years with high tax rates if rates had been lower. The point is simply that the relationship between taxes and growth is complex. Just as nominal tax rates often provide little information as to the real effective tax rates imposed on different individuals and different activities, tax-GDP ratios alone convey no information about the level and productivity of the government infrastructure and services associated with those tax dollars.

### 1.6.2 Growth Strategies

Consider what a tax system might look like if economic growth were the main policy objective. For one thing, to avoid discouraging entrepreneurship and risk-taking, there would probably be little or no taxation of profits since such taxes make these activities less rewarding. In particular, there is little economic rationale for taxing what economists often call *normal* profits, by which they mean (more or less) the average rate of return available from investments with the same degree of risk (that is, the risk that they may lose rather than make money for the investor). On the other hand, a good economic case can be made for taxing so-called supra-normal profits as heavily as possible since, by definition, the additional (above average) return on investment is not needed to induce the activity in question.<sup>21</sup> Although it is not easy to distinguish ‘normal’ from ‘excess’ profit, a number of business tax schemes intended to achieve this objective have been put forward and even introduced to a limited extent in a few countries, particularly with respect to natural resource industries, in recent years.

On the other hand, even if there is little economic case for taxing ‘normal’ profits, when a personal income tax is imposed some taxation of such profits is often needed to prevent people from placing assets in a corporation to avoid personal income taxes.<sup>22</sup> In addition, profits taxes may also be seen as way of ensuring that the public sector in countries that host foreign investments receives some share of the profits earned by foreign investors.<sup>23</sup> On the whole, however, high taxes on profits are most unlikely to form part of a growth-oriented tax strategy. At most a reasonably low and stable broad-based profits (or other form of business) tax may be imposed for the reasons just mentioned.

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the average annual rate of real GDP growth was 4.5%, and the years since 2000, when the average annual growth rate was only 1.5%: in the first of these periods, the tax-GDP ratio rose sharply from 23.7% to 30.1%; in the second, however, the tax ratio decreased from 34.6% to 32.8%. (Data on GDP growth from World Development Indicators (<http://data.worldbank.org/data-catalog/world-development-indicators>); data on tax ratio from Treff and Ort (2010)).

<sup>21</sup> Rather confusingly, economists often call such ‘excess’ profits (or other returns to particular activities that are not essential to induce people to carry out those activities) ‘economic rents’: the terminology is confusing because not only are such returns not ‘rents’ in the ordinary sense of the term but they are also not really ‘economic’ since, by definition, they are not necessary to induce any economically advantageous action.

<sup>22</sup> ‘Integration’ – a method of treating corporate taxes (fully or partially) as ‘withheld’ personal income taxes – was developed in part as a way of reconciling the desire to reduce or eliminate taxes on corporations to achieve growth or other non-fiscal objectives while at the same time sustaining a viable personal income tax.

<sup>23</sup> As discussed earlier, since the economic, social and political context furnishes the framework in which profit-making activity of any kind can take place in a safe and regularized way, it seems both fair and economically efficient for that infrastructure to be financed by those who benefit from it. Non-residents carrying on business in most countries are therefore taxed (on their locally-sourced income) in the same way as residents because their activities depend on and take advantage of the domestic economic, political and social infrastructure in equivalent ways.

A second growth-oriented tax strategy might be to tax consumption more than income. The difference between consumption and income is saving, and from the perspective of encouraging, more saving is usually better than less. If domestic savings are essential to financing domestic investment or if for some (not very clear) reason a premium is placed on having domestic savers invest in domestic investment, an argument can be made for taxing income from savings more lightly or at least for having domestic saving invested in domestic companies taxed more lightly. The particular form of ‘corporate-personal tax integration’ found in Canada, for example, seems to be motivated by some such objective. Most importantly, however, in addition to a relatively low and stable tax on profits a purely growth-oriented tax system may thus place heavier reliance on a broad-based consumption tax such as the VAT.

### **1.6.3 Growth versus other objectives**

What is conspicuously missing in this picture, of course, is any explicit mention of a personal income tax or any concern for fairness in taxation. However, from a broader perspective, such a tax may also be considered to be a critical component of the design and implementation of a sustainable tax system in a democratic setting, just as in Canada and the United States provincial or state access to both income and sales taxes (as well as continued heavy use of the (ancient) real property tax at the local level) may be seen as essential components of the maintenance of a viable and democratic federation. Indeed, the dilemma facing contemporary tax policy designers is essentially how to keep the tax system both compatible with the country’s economic needs in the changing international context discussed in Section 2 and sustainable politically within the domestic political context. We return to this issue in Section 3.

## **1.7 Non-fiscal objectives of taxation**

Governments often use the tax system as a device to induce or alter particular economic circumstances and private sector choices and behaviour to achieve various government objectives. This may involve the introduction and propagation of a variety of tax incentives -- for investment, for savings, for exports, for employment, for regional development, and so on. Often, such incentives are redundant and ineffective, giving up revenue and complicating the fiscal system without achieving their stated objectives. Even to the extent that incentives may be effective, for example, in inducing investors to behave differently than they would have done in response to market signals, the result may often be distorting and inefficient, diverting scarce resources into less than optimal uses. Indeed, some argue that selective tax incentives can improve economic performance only if government officials are better able to decide the best types and means of production than are private investors. On the whole, experience suggests that such non-tax factors as a sound macroeconomic policy, good infrastructure and a stable governance system are much more important factors in affecting business decisions than tax benefits.

Nonetheless, most countries have a variety of special tax incentives that attempt to achieve many non-fiscal policy objectives, ranging from improved access to housing and stronger pension financing to encouraging the adoption of particular ‘green’ or other technologies. Whether or not a good idea in principle, in practice such tax incentives need to be well-designed, properly implemented, and periodically evaluated if they are to do more good than harm.

In principle, the tax system can certainly be used to encourage or discourage certain activities. For example, taxes can be used to correct market failures such as positive or negative externalities. Externalities exist when market prices fail to reflect all the benefits or costs associated with an activity. The classic negative externality is pollution. Firms that pollute affect the welfare of others, often in a way that is outside the market mechanism. The presence of externalities could prompt different types of government action. The government could regulate the activity by providing rules of conduct and penalties for failure to comply. It could establish clear property rights, such that all affected parties would be brought together and bargain in a manner that could result in the parties accounting for the costs and benefits of their activities. An alternative (or complementary) approach may be to use the tax system as a tool to correct for externalities. A tax on pollution may correct for market failure by requiring polluting firms to bear the cost of pollution. Similarly, as mentioned earlier a rationale for special excise taxes on tobacco, alcohol, and motor vehicle fuel is to impose on users of these products an additional cost that in effect forces them to take into account to some extent the negative externalities resulting for others that arise from their consumption decisions.

Even apart from such market failures, policymakers may use the tax system to encourage or discourage certain activities. Various tax provisions are intended, for example, to encourage such activities as retirement savings, gifts to charities, and home ownership. Such activities could be, and in fact sometimes are also be, subsidized directly through grants and other programs or indirectly through the tax system.

Although the costs in term of forgone revenue of most such ‘tax expenditures’ are reported regularly in a number of countries,<sup>24</sup> no formal account is taken of such outlays in the normal budgeting process, so the extent to which such reporting ensures adequate accountability is suspect. For example, we know the (estimated) tax revenue forgone by the tax subsidization of private gifts to charity<sup>25</sup> but there is surprisingly little public discussion of whether the public benefits from thus facilitating the partial expropriation by private interests of activities that are largely publicly funded are sufficient to make such incentives on balance socially desirable.

It may sometimes make economic sense to follow the tax expenditure route to achieving a particular policy goal rather than the economically equivalent route of increasing taxes and then spending the revenues in grants to the favoured activities. On the other hand, one reason some tax concessions are introduced may be precisely because more open expenditures on the favoured activities would be politically more difficult to implement and less popular. A serious potential cost of the tax expenditure route is a loss of control over whether and to what extent the targeted objectives are achieved and monitored. Unlike a grant system, tax expenditures leave to those who obtain the direct benefit (reduced taxes) of those expenditures the manner in which ‘qualifying’ activities are carried out and for whose ultimate benefit. As past experience has shown, unless such expenditures are carefully designed and monitored to anticipate possible abuses or

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<sup>24</sup> In Canada, for example, several hundred such ‘tax expenditures’ are listed in Department of Finance (2011).

<sup>25</sup> Department of Finance (2011) reports that for 2009 the estimated (federal) ‘tax expenditure’ associated with charities in Canada was about \$2.2 billion for individuals, at least another \$0.5 billion at the corporate level, and about \$1.1 billion in the form of GST rebates and exemptions, or in total almost \$4 billion.

leakage to unintended potential claimants, their effects may differ substantially from the stated intention.<sup>26</sup> On the whole, it seems all too likely that in most countries far more tax ‘tinkering’ than is optimal is done in the name of a wide variety of ‘good’ things, with the consequence that the tax system as a whole is substantially more costly than necessary and hence a less efficient revenue-raiser than it could be.

## 1.8 The intergovernmental dimension

Reforming tax policy is always a complex and difficult exercise in any country. It is particularly so in countries like Canada in which both federal and provincial governments have important income and consumption taxes. Both the design and implementation of tax policy at one level of government needs to be carried out with full and explicit attention to the possible reactions of the other level. Tax policy decisions are not made in a vacuum. Nor are they made, as seems sometimes to be assumed, by a benevolent government. Rather, they reflect a set of complex social and political interactions between different groups in society in a context established by history and, among other things, by the administrative capacity of the state. Taxation is not simply a means of financing government. It is also one of the most visible parts of the social contract underlying the state. The success of any tax policy thus depends in large part upon how different political groups perceive the reform and how they react. For example, those who will have to pay more must be convinced that they will, so to speak, get something worthwhile for their money. Those who will not pay more must also get behind reform if it is to succeed. The bureaucracy, those who will have to implement reform, must also support it, or at least not actively oppose it.

Some see the inevitable political processes underlying tax reform as inherently ‘statist’ in the sense that the state can be viewed as an institution in its own right that seeks to maintain and increase its capacity, including its capacity to collect taxes. Others see acceptance of increased tax burdens as inextricably entwined with the expansion of a more democratic polity and a more inclusive society. For citizens to pay more they must get more of what they want. For this process to work as it must -- to be both honest and to be seen to be honest -- the public finances should be both transparent and accountable. For example ‘earmarking’ revenues to favoured objectives - although a practice usually disliked by budgetary and public finance experts because it is all too likely to distort budgetary decisions - may sometimes prove to be a politically essential component of a successful tax reform.

To take an important example in current Canadian public policy, separating tax and expenditure decisions by levels of government to the extent that Canada does with respect to the health area will perhaps not prove to be sustainable in the long run. The long-term solution may lie either in moving more health expenditure decisions ‘up’ to the federal level or more revenue decisions ‘down’ to the provinces in order to re-establish the democratic connection between taxing and spending. In either case, forging a stronger explicit spending-taxation link as well as clearer democratic accountability at both federal and provincial levels may prove to be an essential ingredient in using the tax system in part as one instrument to maintain and sustain federalism and indeed perhaps Canada. As this example suggests, the relevant policy

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<sup>26</sup> For example, the ‘scientific research and experimental development’ tax credit introduced in Canada some years ago spawned a litany of projects of dubious public benefit, and was exploited by various private tax shelter investment schemes to the point where it ended up providing little or no real support to the activities it was supposed to finance.

objectives that shape Canadian taxation may extend much beyond the conventional trinity of equity, efficiency and administrability with which this section began. Much the same may be said in many other countries.

## 2. TAX POLICY IN THE ‘NEW’ WORLD ECONOMY

What is good (or even feasible) tax policy becomes even more complicated when one recognizes that the geographic borders do not define the limits within which tax policy decisions focused on the welfare of citizens take place. Countries no longer have the luxury of designing and implementing their tax systems in isolation. The interdependence of national economies has always been a factor in shaping and implementing social, industrial, economic, and tax policy. In part for this reason, the traditional tax policy paradigm discussed in Section 1 has always been far from comprehensive and may no longer work all that well even as an indicative tool. Historically, the limits of tax and economic activity have been understood and defined largely by reference to the physical connections of those activities with observable trade flows of various kinds. In this world, the communities in which production occurred and was consumed were readily evident and suitable adjustments via various forms of trade and tax regulation could be made to establish or protect the fairness of the implicit international bargain. When, however, what a country produces – and hence supports and finances through its tax system and broader economic, social and political infrastructure – flows through cyberspace (the virtual economy) it may all too easily and invisibly be appropriated by others beyond the country’s limits. In recent decades, the increased mobility of business inputs, primarily capital, across national borders as well as changes in consumption and production patterns have reduced the significance of national borders. Taxes have become a more important factor in location decisions. There is increased tax competition for direct investment, portfolio investment, qualified labour, financial services, markets, and business headquarters. A country whose tax system differs substantially from other countries with which it has important economic connections, may suffer (benefit) as a result. All countries have to some extent lost some tax sovereignty and the adequacy of some traditional tax policy imperatives and design features has come into question.

### *Economic Interaction and Incompatible Systems*

Globalization has, for example, tightened the constraints on tax policy associated with excessive complexity, tax avoidance and tax arbitrage. Incompatible legal and tax systems increasingly encounter each other in ways not contemplated by traditional tax policy. Tax systems do not mesh easily in practice in a context in which there is no overall international tax design or administration. The increased possibilities for tax minimization either as a self-selected choice by taxpayers or simply as a by-product of the interaction of different legal regimes and tax systems reduce the reachable tax base and hence to some extent put at risk the ability of governments to provide public services. This looming ‘race to the bottom’ is exacerbated by the extent to which, with increased financial innovation, the labels that now largely determine who taxes what and how much are losing their meanings.

Economic and tax policy choices must be implemented through legal systems that define (and confine) how economic actors organize their activities and enjoy rights and bear obligations in relation to each other. All legal systems adopt fictions and forms to establish the limits of economic and social intercourse such as notions of ‘property’ and the consequences of dealings through ‘contracts’. Since all such terms are invariably

somewhat malleable, they generally permit economic activity through contracts that may connect economic actors in ways that in effect create a private legal regime between them that the general law cannot reasonably have anticipated. Lawyers and investment bankers can now with relative ease convert equity to debt, business profits to royalties, leases to sales, and ordinary income to capital gains - or the other way around. They can also customize the legal characteristics of economic actors, for example, so that they appear to be corporations in one place and partnerships in another in such a way as to minimize taxes. In attempting to cope with such matters, tax policy everywhere has become more complex. Taxation is no longer simply a matter of tapping fairly well-defined pools of economic value (tax bases) that are closely associated with well-defined political jurisdictions in a world in which the underlying legal and other infrastructure is known and constant. In this new fiscal world it is increasingly difficult for tax administrations everywhere to distinguish (presumably bad) 'tax avoidance' from (presumably acceptable) 'tax arbitrage,' equally, and in part for this reason, it has become even more difficult to translate the objectives and principles of tax policy into the desired results.

#### *The Former Context – Interactions with Seams*

The traditional tax regime for taxing cross-border transactions in most countries rests on a stylized set of facts: (i) small and evenly-balanced flows of cross border investments; (ii) relatively small numbers of companies engaged in international operations; (iii) heavy reliance on fixed assets for production; (iv) relatively small amounts of cross-border portfolio investments by individuals; and (v) minor concerns with international mobility of tax bases and international tax evasion. These assumptions underlie much of the discussion of two common pillars of international tax policy architecture -- *capital export neutrality* (CEN) and *capital import neutrality* (CIN). These concepts in effect attempt to extend the common criteria of equity, efficiency and administrability discussed in Section 1 explicitly across international borders.

For example, CEN asserts that 'home' and 'away' investments should be treated identically so that capital will flow where it may best – from a world perspective -- be used. In contrast, CIN focuses on whether there are tax-induced biases that would prejudice the use of imported capital in a jurisdiction by exposing it to taxation not faced by competing local enterprises. Neither approach is without problems but in practice CEN – the *residence principle* -- generally rules, at least in principle, with respect to the taxation of *passive (investment) income* (that is, income that is not earned through active exertion by the taxpayer away from the home jurisdiction and that has no necessary geographic or jurisdiction connection other than where the taxpayer is located). On the other hand, CIN – the *source principle* - is more commonly associated with *active (business) income*, the premise being that there is a reliable, necessary, observable connection of the income-earning activity to someplace other than the place where the taxpayer legally resides. In this case, the first claim to tax revenues goes to the location of production (the source) and the home (residence) tax is correspondingly eliminated or reduced. Whether this traditional distinction between residence and source tax policy poles is helpful in defining the kind of taxable connections that now exist between taxpayers and tax systems is debatable (Bird and Wilkie 2000).

In Canada, for example, the Royal Commission on Taxation (1966) developed a logical and consistent domestic tax policy framework essentially on the assumption that Canada was a closed economy and then treated the international dimension as something that



could be ‘fixed up’ along the lines just sketched once Canada got its domestic tax system ‘right.’ This approach did not work well then. It certainly does not work now. Given the importance of international developments to Canada and the erosion of technological and physical impediments to cross-border economic flows, the distinctions between home and foreign (or onshore and offshore) established by the traditional paradigm do not provide clear guidelines in dealing with the ‘new’ international fiscal economy. International concerns can no longer be relegated to a secondary ‘add-on’ role in formulating tax policy in economies open to extensive trans-border flows.

### *The New Context – Seamless Interaction*

Over the last few decades, many business operations have changed drastically in the direction of dispersing production, with different though nevertheless integrated operations taking place – in reality or at least on paper -- in different countries. The share of total value-added – the ultimate tax base -- arising from services and intangibles has increased and made it more difficult to locate the source of corporate income or taxable activities sufficiently clearly in space (or time) for any country to tax that income with a demonstrably superior relative claim than other countries involved. For similar reasons, although to a considerably lesser degree, it has also become somewhat harder to tax personal income both because it is easier for individuals to earn income outside of their country of residence and because traditional employer-employee relationships have increasingly been evolving into independent contractor status, with more and more ‘owner-managers’ being able to convert labour income relatively simply into capital income.

At the same time, the challenges posed by electronic commerce and more generally the ability to transfer information, money and even the performance of tasks invisibly without the need for a visibly necessary presence anywhere -- including where the output is consumed -- have made it more difficult for consumption taxes to compensate for the declining reliability of the income tax base. Sellers can increase sales without having a physical presence in a country, and the increased importance of digitized products makes collecting taxes more difficult.

None of these factors – except to some extent with respect to the taxation of international corporate income -- as yet constitutes a proven ‘tax killer.’ Taken together, however, it seems likely that countries in the 21<sup>st</sup> century must design and implement tax policy very much in an international context. This section explores some of the ways in which this new international world may affect what countries can do to achieve national policy objectives through tax policy.

## **2.1 The internationalization of tax policy and administration**

National tax systems are confronting each other in unprecedented ways as the economies they support increasingly engage with each other. What has not changed, however, is that each country has its own tax system intended in part to frame, fund and achieve national social, political and economic goals. Good tax policy cannot be divorced from the underlying social, political and economic goals that motivate it. Nations do not necessarily share common goals, and their different choices to some extent manifest themselves in tax system choices. Nonetheless, the interactions of different economies and fiscal systems create a certain degree of unavoidable mutual dependence.

The increasingly pervasive international aspect of tax policy may surface directly in response to other countries' choices: as early as the 1970s, for instance, Canada introduced a new system of accelerated depreciation for manufacturing and processing in part as a response to a tax export subsidy established by the United States. More recently, many countries have engaged in competitive downward moves of corporate income tax rates. Reflecting this, much recent discussion of international tax policy reform has been driven by the interests of multinational and global business enterprises in synthesizing a competitive effective international tax rate. Although these enterprises exist as constellations of separate accounting entities, they are economic units that are constantly, through various intra-firm dealings, re-establishing their economic unity in relation to similarly placed enterprises. The transfer pricing issue in tax policy is concerned with detecting when such dealings cross justifiable economic limits and in effect become devices to redefine and shift 'profits' to where tax is least. Since there is no international tax system as such, in effect the artificial subdivision of economic units into legally separate accounting units results in a process of fiscal self-help as economic actors mix and match elements of the different tax systems facing them until their tax cost of doing business is comparable (or lower) than that of their competitors.

From a tax rather than business perspective, 'internationalization' in various guises may emerge from the adoption of such tax policy norms as the CEN and CIN approaches mentioned earlier, or most explicitly – and collaboratively -- through bargained accommodations by way of tax, trade and other treaties. The main playing ground currently is how to measure and tax international business income earned indirectly through foreign legal constructions – foreign affiliates or more generally controlled foreign corporations. Whether and how taxation of such income should be deferred and any foreign tax recognized, is far from a decided issue. The CEN approach is to apply the home tax system without regard for where the income is earned, crediting foreign tax up to the home (residence) country tax liability. The CIN approach is to give primacy to source country taxation by exempting such income from residence country taxation, on the grounds that doing so is in the residence country's ultimate economic interest. Both approaches focus on the effective income tax rate and assume, rather optimistically, both that domestic and foreign income measures are appropriate and that all relevant expenses are appropriately aligned with domestic and foreign revenues respectively.

When national economies are relatively autonomous, countries have considerable latitude in pursuing their own distinct policies. The quite different notions of competition embedded in CEN and CIN are not a big issue when the elasticity of capital flows to effective tax rates is relatively low. However, as the economic context becomes more open and 'soft' production inputs (e.g. various manifestations of money or finance and such intangibles as know-how, knowledge, experience and the like) become more important, matters change. The need to accommodate each country's tax system to the different tax systems found elsewhere becomes unavoidable. Tax policy options and tax administration techniques formerly considered unthinkable may have to be reconsidered. For example, reliance on income taxation as the primary revenue source becomes more questionable when it becomes increasingly difficult to define what income is and where it is earned. In such circumstances, more reliance may have to be placed on taxes based on more directly observable and measurable bases such as consumption, payrolls, and property.

As already noted, such problems are most noticeable with respect to international business income. The commonly accepted *arm's length standard* for measuring and allocating among taxing jurisdictions the international income of business enterprises is intended to provide a basis for national taxation of the 'correct' share of such income. To do so, however, this approach applies traditional conventions based on separate entity accounting to multinational and global corporations that consolidate commercial activities organized and operated along functional lines according to centres of business interest. Applying the traditional paradigm assuming economic units that can meaningfully be divided into legally separate components for tax, management accounting or other purposes flies in the face of reality. Multinational enterprises exist precisely to avoid the costs and limitations of dealings between unrelated parties. The 'economic rent' such firms obtain by operating as a single economic entity that avoids these costs and limitations cannot be properly captured and allocated by the prevalent tax approach. National tax administrations need effective institutional ways to tax such enterprises, but characterizing them in a manner that directly contradicts their essence and manner of operation does not seem to be a promising path to sustainable tax policy. Indeed, the effort to make such an approach workable may result in its becoming so reliant on a series of fictional assumptions – conceived initially as practical expedients to adjust for possible profit distortions attributable to common control -- that over time the inherent weakness of this approach becomes magnified and compounded to the point that it becomes unworkable and unadministrable.<sup>27</sup>

One answer to this problem may, as already suggested, be a fundamental reweighting of national tax policy leading to a reduced emphasis on income taxes that to some degree have already become for many enterprises almost discretionary in their impact and unpredictable in terms of revenue. A quite different approach, however, is to focus on the practical regulatory dimension of the emerging new world economic and tax policy order. The seeds of such an international approach to tax regulation may be found in various more or less formal interactions of tax policy and regulatory authorities such as the OECD's Global Tax Forum and various associations of tax administrators such as the Forum on Tax Administration, the Joint International Tax Shelter Information Centre, the OECE's Global Tax Forum and the Leeds Castle Group, as well as in a plethora of new ways of formalizing the exchange of information among tax authorities.<sup>28</sup> Countries have increasingly been sharing financial and tax information, through a plethora of Tax Information Exchange Agreements (TIEAs) in addition to information exchange arrangements contained in bilateral tax treaties. In principle such agreements are intended to limit the possibility that income can be hidden from interested tax authorities; in practice, however, success in this respect remains elusive. One way or another, however, both tax administrators and tax policy makers are

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<sup>27</sup> The OECD's Transfer Pricing Guidelines started out as devices to provide valuation guidance in identifying when and to what extent there were distortions in the distribution of 'profit' within a group attributable to the possibilities for manipulation engendered by common control. It is far from clear that the application of these guidelines as transactional accounting standards is or can be adequately matched by the legal concepts and tax system features necessary to give them life.

<sup>28</sup> The OECD (Organisation for Economic Co-operation and Development) is a Paris-based group of (now) 34 countries, most of which are relatively high-income countries: a recent overview of many of the issues discussed here may be found in OECD (2013). The Forum of Tax Administrators (FTA) is a panel of national tax administrators established in 2002 by the OECD's Committee on Fiscal Affairs to promote dialogue between administrations. The Leeds Castle Group is a group of tax administrators from a number of major countries, including some non-OECD countries like China and India, who meet regularly to discuss mutual compliance problems. The Joint International Tax Shelter Center was established by the U.S., U.K., Canada and Australia to develop and share information on abusive tax avoidance.

becoming increasingly well informed about and influenced by developments and approaches in other countries.

Tax policy has always been to some extent a ‘best practices’ approach. However, the past is not the future. Those concerned with the design and implementation of tax systems need to look ahead and consider carefully whether the policy and administrative mix that best achieves the underlying public policy objectives of taxation should change and, if so, how it should change. The balance of this section explores the extent to which the increased internationalization of taxation suggests that it may be necessary to abandon some historically accepted best practices and to adopt new ones.

## **2.2 Evaluation Criteria: The Framework for Identifying and Measuring Objectives**

Even if a country gets the economic analysis of its tax system right, so long as national legal and tax systems do not align fully questions arise about how tax policy can be effectively implemented. Legal infrastructure can be critical in determining policy outcomes in practice. Essentially, four important questions must be decided in order to implement any tax policy: What? Who? How? When? Unless the answers to these questions are clear and appropriate, and both captured by and enforceable within a country’s legal system and tax regime, the effectiveness with which even the most intuitively sound and thoroughly conceived tax policy can achieve its intended objectives may be questionable.

### **2.2.1 What – The Taxable Object**

To be captured by the tax system, the tax base – the economic value that is subject to tax -- must be both identifiable and clearly defined either through specific rules or in a relevant general law that supplies the definition and is sufficient within existing legal conventions and practices. This task can be very complicated in an international context. Many legal (and tax) systems treat such definitional issues quite differently. The interaction of national tax systems requires some measure of mutual recognition of these definitions if the results are not to be either ineffective or distortionary. For example, recent OECD attempts to revise the Transfer Pricing Guidelines to deal with such issues as business restructuring and intangibles like ‘intellectual property’ are critical in order to get at the inherent synergies and efficiencies that are the hallmarks of multinational and global business enterprises. However, there is no common international understanding of what exactly constitutes an ‘intangible.’ Even the best-defined economic conceptualization does not fit easily within existing national legal and tax systems. This is a much more important challenge to developing a coherent and effective international tax policy than is usually recognized: in the absence of an agreed legal formulation, getting the economics right is like thinking important thoughts without having either the facility of language to express them or the linguistic conventions necessary to translate from one language to another.

### **2.2.2 Who – The Taxable Object**

Even assuming that the object of taxation can be captured satisfactorily by the tax law, that object must then be associated with a particular economic actor whom the tax system recognizes and holds accountable and from whom the tax can be readily collected. Since the norms of public international law generally prohibit extra-territorial enforcement of tax laws, the enforcement by any country of even the most well-designed ‘international’ tax system inevitably stops at the national border. This is a major

problem in the ‘world without (economic) borders’ that has to some extent developed in recent decades. One result has been to put pressure on commonly accepted conventions for defining the characteristics of a ‘taxable person’, particularly with respect to taxing corporations. As noted earlier, a corporation is essentially a legal fiction: although corporations are the focus of much commercial activity and play critical economic and fiscal roles, they have no intrinsic economic ‘being’ or even legal personality separate from their economic owners other than that bestowed by law. Indeed, as was also mentioned earlier, corporations – even if there were full international agreement on the characteristics of this business form<sup>29</sup> -- as such cannot really pay taxes in the sense of bearing their final incidence. To determine who really pays taxes imposed on corporations one must in effect look through the corporation to the natural persons who gain or lose when taxes are collected at the corporate level, and, as discussed in Section 1, we know very little about the real incidence of the corporate income tax.

Much the same is true with respect to trusts, which are in legal terms simply an obligation undertaken by one person (a *trustee*) to another (a *beneficiary*) at the instance of a former owner of property (a *settlor*) in relation to property and its derivative income (the *trust corpus*) intended to be deployed as originally determined by the settlor but according to the discretion of the trustee in order to serve the material interests of the beneficiary. In other words, a trust is a special form of relationship among persons. Canadian tax law, for instance, gives a trust the legal personality it otherwise lacks separate from its constituent interests, in order to establish a reference point – a taxpayer – and to capture within the tax system changes in the value of and income from the settled property. However, even within a single country, it can be difficult to deal with focus points for value that lack both personality and a clear connection of a person to a place and of both to a property, as Canada’s recent experience with ‘income trusts’ demonstrated.<sup>30</sup>

From one perspective, the enforced integration of the taxation of business income that was achieved through income trusts (where the income earned by the entity was ‘flowed through’ the trust and taxed only in the hands of its beneficial owners) in effect yielded a simple (and, some might say, efficient) result by treating business income roughly equivalently regardless of the legal construction – corporation, trust or partnership – within which the income is captured and from which it is allocated or distributed to its economic owners. From another perspective, however, real tax avoidance opportunities may arise from imperfect attributions of ‘personality’ in such arrangements – in this case in terms of establishing precisely who the taxable actor is with respect to the taxable object (the trust property). Tax policy analysis does not stop with the immediate trust actor but must also foresee how the presumed owners of the income are treated in relation to the flowed-through income. For example, to the extent that the income

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<sup>29</sup> One of the many challenges when legal and tax systems interact is the incompatibility of notions as fundamental as the definition of the taxable unit. A corporation in one country may be considered a partnership or branch elsewhere; such differences have fundamental implications – for instance that some transactions in one country may not be recognized as such in the other. Tax policy that does not take such matters into account is deficient: for an example, see the Canada-United States Income Tax Convention (Fifth Protocol, Articles IV (6), (7)) which limits relief otherwise provided by the treaty when a ‘resident’ of one of the treaty partners is disregarded in the other.

<sup>30</sup> For some discussion of this issue, see Mintz and Richardson (2006) as well as a number of other articles on the topic subsequently published in the same journal.

belongs to tax-exempt persons, such as certain deferred income plans, the result may be what from a policy perspective may be considered an intolerable delay in taxing the income despite the theoretical attractiveness, from one perspective, of integrating the income ‘earner’ and ‘owner’.<sup>31</sup> Whether such arrangements constitute tax avoidance and whether such avoidance is to be corrected depends largely on the objective expectations for taxing such value and the rationale for such expectations. It is by no means easy to determine the answer to such fundamental questions even within a purely national context, let alone in the much less well determined international context.

### **2.2.3 How – The Taxable Transmission of Value**

Even when the taxable object is identified as well as a taxable actor to be held accountable the manner in which the value – the object – is manipulated may matter. Typically, the law recognizes a change in the relative interests of actors in a taxable object when there is a disposition (sale or other transfer or letting for use) of the object or the performance of some sort of service. It is this act that gives rise to an identifiable and measurable income or other outcome that in turn occasions tax. In the international arena, however, there is often no common understanding among countries, especially when the taxable object is ill defined or can bear more than one characterization, as to who can be held accountable for its manipulation or even when such an activity takes place.

### **2.2.4 When – Timing Matters**

The best theoretical tax policy construct is not much use if no tax can be collected or if the limits of tax avoidance cannot be determined and addressed in an objectively definable and enforceable way within a reasonable period of time. When is a transmission of value a taxable event, and with what other taxable events should it be associated in order to ensure that the tax base accords with internally consistent tax policy principles formulated and applied with the unique demands of internationalization in mind?

A topical example of this problem that countries are now rethinking relates to the alignment of financing charges (interest) and the income-earning activities that are directly or indirectly financed. This problem, sometimes described as (or associated with) ‘debt dumping,’ is being addressed by different countries in different ways, most of which are related to the *thin capitalization* rules that exist in many tax systems. These rules are intended to police excessive income transfers arising from debt service that has been arranged to benefit entities beyond the jurisdiction of the country within which a particular entity is located. Although the issue of limiting interest deductibility has sometimes been approached as a domestic tax shelter issue, it is generally driven by a fundamental international question, namely the extent to which a country’s tax system is prepared to cede tax base in favour of another country to which the affected tax subject and/or tax object, and related income, has a connection. How much recognition of foreign taxes whether by credit, exclusion of income or otherwise, is justifiable, and why? If financing expenses are recognized in relation to a source of income to which they do not really relate, then foreign income will be overstated. Even if the tax rules of

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<sup>31</sup> The collision of these tax policy considerations, in the case mentioned above led Canada to adopt a corporate tax model with two primary features: the introduction of yet another entity concept – the ‘specified investment flow-through’ (‘SIFT’) trust – as well as rules to assimilate public investment trusts and partnerships to corporations and the refinement of the dividend tax credit for distributions on corporate shares to ensure better integration of corporate and shareholder taxation.

the country in question attribute the financing charge to the foreign underlying income, the final outcome of the national disallowance of a financing charge is unclear since that outcome depends on how both the foreign country and the multinational firm react. Once international considerations are introduced, tax policy becomes enormously more complex because it must consider not only potential taxpayer reactions but also those of other taxing jurisdictions.

### ***2.2.5 Defining the tax base – necessary accommodations***

This brief discussion of four of the key building blocks of any income tax system illustrates some of the ways in which why international developments may force some rethinking of tax policy conventions. The underlying theme is that there are increasingly practical as well as theoretical limitations to the usual guidelines of taxation set out in Section 1. No country is likely simply to abandon its tax claims in favour of the interests of another country when it comes to taxpayers having some recognizable connection to both unless there is a significant reason to do so in its own interests. Indeed, it is this axis of interest – country to country acting as if they were economic actors in relation to each other through their respective taxpayers – that accounts for the internationalization of tax policy and rules, and gives rise to the complex administrative web manifest in tax treaties, information sharing, transfer pricing agreements among taxpayers and tax administrations, and the like. However, it is hard to discern very clear thinking about the objectives of international tax policy in the way international taxation currently works.

Provisions such as those on controlled foreign corporations and foreign tax credits found in national tax laws, like the many tax treaties that now exist, are perhaps best considered as pragmatic attempts to accommodate the many physical and legal ways in which commercial activities actually take place by adding on particular features to tax laws developed essentially for domestic purposes, without focusing on how the new international aspects interact with and may fundamentally alter the achievement of the various domestic tax policy objectives. This is changing. More fundamental questions are being asked about how tax systems sit atop the legal system that gives them definition – notions of property, contractual dealing, transfer events – and how the changing roles of members of a multinational or global enterprise leads to ‘transmission’ elsewhere of the economic value thought to originate in a country.

Although agreed answers are hard to find, taxpayers and their various governments have in effect been communicating with each other both through language and through commercial relations. Conceptually, it may even be possible to imply or infer the implicit evolution of a sort of loose confederation of a number of more developed national tax systems perhaps not all that different in some respects from the more formal arrangements that exist within federal countries such as Canada to co-ordinate the contemporaneous application of the federal and provincial tax systems on similar income and consumption bases. We develop this thought further in Section 3 below. Equally, however, what current international tax rules and practices illustrate may be less a principled justification for their continuing acceptance and use than a last ditch rationalization for clinging to outmoded practices and constraints. Time will tell.

In any case, as noted earlier, it seems clear that many productive inputs (including skilled people) are more mobile and less connected to particular countries than ever before. Nations, through their tax systems, are hence increasingly competing for the potential tax base generated by such inputs. In the search for revenues, as borders are

less and less the prime determinant of where the fruits of economic activity or necessary capital reside, tax systems may need to utilize whatever connections or ties to the potential tax base they can assert.

From a more positive perspective, one might perhaps argue that there is now in effect a larger shared interest among competing tax systems and, correspondingly, heightened awareness and responsiveness in each country to the economic and tax policy characteristics of other tax systems. In other words, tax policy objectives associated with such hitherto theoretical concepts as *inter-nation equity* ('fair' international sharing arrangements) have arguably become more important.<sup>32</sup> This line of thinking points in the direction of the need for more explicit agreements among jurisdictions as to who should tax what and how much -- if only to ensure that anyone is to be able to tax much in any fashion.

At the same time, however, the increased importance of cross-border tax bases moves administrability issues to the forefront. Even the best-designed international (or, for that matter national) tax will not work if it cannot be reliably collected -- for instance, because some key parameters are porous or indefinite, or because it is simply too complex to expect adequate compliance even from diligent and honest self-enforcers or adequate enforcement from even the best tax officials.

### 2.3 Rethinking the parameters of tax policy

One way or another, the message seems clear: a relatively open economy cannot conceive its tax regime in isolation. It must increasingly do so in relation to the tax regimes in place (or expected) in other jurisdictions. International tax policy may perhaps best be thought of as domestic tax policy adjusted to accommodate adequately the nature and transmission of high-value economic inputs (factors of production) as well as outputs across borders, in a world in which most economies are relatively open and have, to some extent, dynamic influences on each other. Accordingly, to be both sound and sustainable domestic tax policy must attempt to foresee critical developments abroad and accommodate them in its own interest. One aspect of this concern relates to identifying elements of interconnected international policy behaviour that may impair otherwise desirable international economic integration. Importantly, however, another important aspect is to weigh such underlying public policy objectives as preserving the nation and domestic self-interest (national welfare, as the economic literature often calls it) carefully and explicitly in relation to tax policy choices that some may suggest are required in the interests of international tax policy compatibility and more successful integration with the international economy.

Much of the current international tax regime, from the League of Nations in the 1920s to the World Trade Organization in the 1990s, derived from decades of effort to reduce both the distortionary effects of multiple trade taxes and the use of such taxes to shape, colour and subsidize trade -- efforts that continue to this day as witnessed by the OECD's continuing efforts to establish a common international basis for taxing digital services. The sorts of questions debated by League of Nations experts in the 1920s, like the language of that debate, are eerily similar to present international tax policy debates. Similar efforts are underway at various international and cross-national levels to grapple with the even more difficult (and considerably broader) problems that arise from the

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<sup>32</sup> For a useful recent discussion of inter-nation equity, see Brooks (2009).



increasingly large share of income arising from such ‘footloose’ factors as intangibles and financial structuring.

Practical tax policy and tax administration is necessarily driven by the observable characteristics of economic systems, legal systems and business constructs on the basis of which potentially taxable tax bases can be identified and measured. The basic problem is that many of the key constructs on which current tax systems rely are essentially fictional -- such as corporations and various self-selected outcomes (for example, through elections (optional choices) to characterize a particular activity or tax actor in a particular way). The fictional underpinnings of fiscal outcomes become accentuated as economic systems and business constructs more and more reflect the significance of such intangible inputs as organizational and knowledge-based intangibles that may not even be forms of legally protected property. In some instances the functioning of the tax system may depend not only on the relevant actors (firms and tax administrations alike) using accepted legal norms but also on concepts and procedures that either do not have a normative analogue or may simply be made up to suit the immediate needs of tax regulation. For example, much contemporary international transfer pricing now works more or less like this. Such fictions may be useful, even necessary, to make the system work at all. However, as they accumulate over time the system as a whole may become less coherent as the fictions are increasingly tested by circumstances with which they were not meant to contend. The present patchwork of administrative devices and practices may have become so intrinsic to orderly tax administration that by default it has become ‘the system.’ National tax systems that rest on such shaky foundations cannot be reliably or compatibly co-ordinated with the equally shaky systems of other countries. Ideally, the parameters of a tax system need to be capable of being grounded in a legal system in a cogent and understandable way as well as in a way that reflects a measure of predictable symmetry with the reactions of other countries.

In the international context, for example, it may be that the first step towards designing a coherent and practical tax framework is to reverse the current situation and to acknowledge that the focus should be on the *source* of economic contributions rather than the *residence* of persons and entities who may or may not be responsible for those contributions in ways that can be distorted through convenient manipulation or movement of responsibility for activity. If the objective is to capture within the tax base activities that have a measurable and observable connection to a country in such a way that the economic actors held accountable to pay the tax do so within the framework of the parameters of equity, efficiency and administrability discussed in Section 1, then almost certainly the tax system should focus primarily on activities that are clearly economically connected to the country. This focus limits the extent to which either the tax base or the mode of taxation can be manipulated by those outside the domestic economy (and polity) who neither fully benefit from the tax-financed economic, social and political infrastructure nor can be held fully accountable to contribute to it -- non-residents, to use the typical terminology, whose interests and responsibilities are not the same those of ‘full tax citizens.’

One strand of recent attempts to cope with the growth of mobile intangible factors has been an international push to homogenize tax systems in part through administrative determinations and guidance exercised by way of a kind of informal international tax administration among major countries. Such efforts may be helpful in terms of aligning tax regulation with the characteristics of the economic actors affected by taxes and the

economic context in which they operate. On the other hand, such moves also imply that countries are silently relinquishing some control over the objectives and characteristics of their tax (and economic) systems. This basic problem is buried in the context of the many specific questions that many countries are now trying to deal with in the international context. For example, although tax discrimination between residents and non-residents is foresworn in tax treaties, countries usually find their way around this prescription through tax expenditures and similar indirect routes as well as by drawing the boundaries of 'discrimination' in treaties so that the use of the tax system to attain policy based fiscal and economic objectives is not forbidden because it is not 'discrimination.' Such considerations suggest that it is perhaps time to think through more explicitly how the international and national dimensions of tax policy design and administration may be better balanced within a broader policy context.

A related issue is the extent to which dominant economic actors may be able to organize or systematize their interactions with national tax systems, through, for example, advanced pricing arrangements/agreements (APAs), which are in effect pre-agreed transfer pricing arrangements. Unless considerable care is used in defining and establishing taxation parameters in such agreements, the achievement of more fundamental tax policy objectives may be imperilled. Clinging to such well-entrenched rules as the arm's length paradigm for measuring the international allocation of multinational income earned through highly integrated activity that increasingly depends on elements not uniquely associated with any particular place presses the limits of self-interested but interdependent national tax policies. As emphasized earlier, multinationals exist essentially because they can increase their returns by obviating the constraints of arm's length dealing; defining their activities for tax purposes by separate entity financial accounting simply cannot capture their integrated and consolidated operations in any sensible way. The more outcomes depend on fictions antithetical to the economic notions and actors to which they apply, the more unreliable, political and disputatious international taxation becomes because there is no reliable reference point to resolve disputes on a predictable basis.

All of these considerations connect to tax administration. What are the norms of acceptable tax compliance? One country's avoidance may be another's fiscal enrichment. In some instances, clever international tax planning may even result in an absolute diminution in the tax base, creating a sort of 'super' private return to those who best play the game of tax planning devices, holding companies, tax-preferred jurisdictions etc. To put the problem another way, what is 'excessive' tax avoidance, that is, when does legal tax planning go beyond the pale by bypassing domestic norms and escaping the limits of the tax system completely?

Although it may seem paradoxical, in some instances it may make policy sense in terms of achieving more important economic and political objectives for a country to relinquish reliance on traditional constraints on avoidance. This is more or less how nations originally approached the issue of international tax policy in the early twentieth century when the League of Nations tried to relieve gratuitous tax-induced impediments to trade by tackling the nature and significance of international taxation. The modern child of these parents is the notion of tax-base sharing through treaties, seen as fiscal and economic bargains between countries each of which is acting in its own national self interest, as well as the less formal emerging international tax administration arrangements mentioned above. In the modern context, however, with the substantially increased 'international' dimension of the tax base, the question becomes whether any

tax policy choices can really be thought of as purely ‘domestic’ if in the end they must be compatible with different choices made by other countries with which the ‘domestic’ tax system is joined by force of circumstances. Who really controls the tax base?

### 3. THE NEXT GENERATION OF TAX POLICY OBJECTIVES

#### 3.1 Reconsidering basic tax policy questions

Section 1 discussed several tax policy objectives and design criteria. For the most part, that discussion implicitly proceeded as though countries could decide how to tax in complete autonomy. As discussed in Section 2, however, in the modern world this assumption is increasingly being tested. Some basic questions about tax policy need to be reconsidered in this context, particularly with respect to the taxation of international business and capital income but also, more generally, with respect to such broad-based taxes as value-added and income taxes.

*What is the tax base?* In a more open economy should more attention be paid to consumption-based than income based taxes? The present income tax in Canada, for example, is to a considerable extent already really a consumption-based tax through its treatment of both pensions and housing: should the current ‘hybrid’ income tax system shift even further towards a more explicit consumption-tax base? If it were to be shifted, how should the regressive elements of consumption based taxation be addressed in order to satisfy the fairness concerns discussed in Section 1?

*Why should some or all the tax base potentially associated with foreign operations of domestic business be freed from tax?* At present, for example, unless repatriated most earnings of Canadian firms operating abroad are not taxed in Canada. If the expectation is that the result of this policy is compounded economic returns for the country that exceed the present value of this tax cost, how can this be tested and measured? Can policy-makers distinguish meaningfully between facilitating international competition in terms of the interests of private parties and doing so for national economic interests? If they cannot do so, then what should they do?

*When (political) geography ceases to align with (economic) reality, do current approaches to the international aspects of tax policy design and administration provide an adequate or appropriate way to deal with this issue?* Tax systems to some extent have always competed with each other for shares of a shared tax base; they do so today more than ever. When countries’ interests collide, historically solutions have been reached either through conflict or, in one form or another, through cooperation. To the extent that consumption and production have less and less attachment to political geography so that the funding of public expenditure depends to a significant extent on factors outside political borders, the integrity and sustainability of the political state is inevitably affected to some extent. Few issues are more important in determining tax policy today than deciding how to cope with the international environment. The relative weights to be attached to the traditional equity, efficiency, and administrative (simplicity, feasibility) aspects of international tax policy need to be reconsidered in this context.

#### 3.2 The limits of government intervention

Standard public finance theory identifies three aspects of government intervention in the economy – stabilization, distribution and allocation. The first two of these objectives are usually associated with central government policy while to a considerable

extent the last, allocation, is the task of subnational governments. Arguably, however, when forces exogenous to the nation may, as the recent financial crisis shows, effectively override national control over stabilization and distribution to a considerable extent then in many ways the main role left to the central government too becomes the allocation function. In these circumstances, the highest order of 'government' in effect becomes little more than a sort of overarching supranational congeries of loose economic and legal arrangements that rely entirely on 'market forces' (including 'political markets') for enforcement purposes. National tax systems to some extent become more like subnational tax systems when the world in which they operate is such that national tax policy outcomes are shaped in part both by international commercial arrangements and by various types of formal and informal regulatory collaboration among tax authorities (as well as specific accommodations in treaties and other legal arrangements). If so, there may perhaps be some lessons for national tax policy to be learned from how subnational tax systems work.

### **3.3 Multilevel Taxation**

One principle of taxation in a multilevel system is that, to the extent possible, each level of government should limit the exercise of its taxing authority to what it can do. In effect this is a modified version of the benefit principle that contemplates some measure of correspondence between taxes levied and the benefits garnered by those paying the taxes. Taxes with broader societal objectives, intended either to define the major parameters of the social system or to redistribute resources within it, do not fit easily within this paradigm. For this reason, stabilization and redistribution seldom rank high as objectives of subnational tax policy both because such general taxes have effects and purposes that transcend an immediate connection to their payers and because in open subnational economies it is difficult to impose and administer those taxes in an equitable and efficient way. In most countries, the gap between those expenditures that can and should be efficiently carried out at the subnational level and those taxes that can be effectively, efficiently, and equitably administered at that level is closed through government-to-government accommodations akin to the intergovernmental revenue and transfer agreements in federations like Canada and Australia.

In addition to such arrangements, in a closed system like the Canadian federation in which several levels of taxation co-exist, generally within well defined and controllable boundaries, questions about revenue losses and other problems that might arise from imperfect interactions between levels of taxation or as a result of transaction or other manipulations by taxpayers can be addressed. However, none of this is true when as sketched above with respect to the current international scene the central 'authority' to which a country is to some extent subordinated actually exercises no real international tax authority. The result, of course, is that taxpayers are sometimes able to manipulate imperfections in the characteristics and interactions of tax systems in such a way as to reduce the aggregate international tax base.

### **3.4 National tax policy is not national**

While it would clearly be wrong to exaggerate the extent to which national fiscal autonomy has as yet been neutered in this way, it nonetheless seems prudent to consider how more principled tax policy responses to the international pressures sketched in Section 2 might be developed. The traditional tax policy criteria of equity, efficiency, administrability and their derivatives set out in Section 1 may be imperfect and incomplete. Nonetheless, they still provide a useful framework within which to balance

these factors more explicitly even within an open economy framework. The traditional paradigm, such as it is, need not be replaced. In fact, the specific features of tax policy oriented to subnational governments reflect refined applications of the traditional paradigm, and one way to begin the task of rethinking the traditional tax policy paradigm may be to consider more carefully the conventional discussion of the appropriate tax instruments for subnational jurisdictions.

Four criteria may be suggested to guide the design of subnational taxes:<sup>33</sup>

- (i) The first, derived clearly from the efficiency criterion, is that subnational taxes should not distort resource allocation (unless, of course, there are clear and significant net gains in terms of non-fiscal policy objectives from doing so).
- (ii) The second criterion is accountability in the sense that subnational taxes should be both politically transparent and visible in order to ensure that the governments imposing such taxes are clearly accountable to those for whom they are supposedly acting – their residents. Both these criteria are of course satisfied if taxes are imposed in accordance with the benefit principle so that those who benefit (from the public services financed), those who pay (in terms of the final incidence of the taxes), and those who ultimately ‘decide’ on taxes are responsible and accountable to the same set of people.
- (iii) Thirdly - and even more ideally given the heterogeneous nature of most countries - subnational taxes should be adequate and sufficient to finance expenditure needs (at least of the richest subnational jurisdictions).<sup>34</sup>
- (iv) Finally, in order to be effectively implemented, subnational taxes should have relatively immobile bases in the sense that the responsiveness of the tax base to rate changes (its rate elasticity) is low and the tax is visibly based on property and personal interests that are clearly related to, and preferably clearly observable in, the tax jurisdiction in question.

These parameters are not as strict as they may seem at first glance. They do not, for instance, imply that subnational jurisdictions can or should tax only real estate. In fact, as Canadian experience shows, it is possible for provinces – and conceivably even localities – to tax such mobile bases such as employment and consumption provided adequate ‘supra-jurisdictional’ administrative institutions are developed, as in the extensive federal-provincial tax agreements found in Canada as well as such commonly-agreed federal-provincial rules as those on profit allocation. Nor do the points listed above suggest that it is either impossible or undesirable to attempt to exercise flexible authority over the nature and degree of taxation – for example, to achieve redistribution or targeted incentive effects through taxation. They do suggest, however, that the limits

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<sup>33</sup> For a recent review of the relevant literature (in the context of developing countries), see Bird (2011).

<sup>34</sup> Countries may, or may not, choose to ‘rebalance’ subnational finances by establishing, as Canada and Australia have done but the United States has not, some ‘equalization’ system of fiscal transfers to those regions with fewer fiscal resources.

on such measures are much tighter at the subnational level and that the likely effectiveness of such measures is more limited.

On the whole the general lesson suggested by considering subnational taxation is that in an open economy the tax system is likely to work best if the demands put on the tax authority for revenue do not exceed its feasible grasp – for instance by trying to extend its authority to sources and persons (non-residents) beyond its reach. Globalization need not result in the dread ‘race to the bottom’ for the national public sector, just as ‘provincialization’ has not noticeably hampered the development of the Canadian public sector at either the federal or provincial levels, let alone in total. However, in the international context – which differs sharply from the national context owing to the absence of any overarching fiscal authority -- the result is likely to be that it will become increasingly difficult to resolve policy problems simply by expanding public expenditures (or equivalent ‘tax expenditures’) and expecting the tax system to be able to keep up.

### 3.5 Looking forward

In short, the next generation of tax policy changes in countries heavily dependent on international developments will likely have to take more explicitly into account the limitations on national fiscal autonomy imposed by a shrinking economic world. When the traditional closed economy analytical box no longer adequately encompasses the critical marginal (international) component of the tax base tax policy choices will increasingly have to be framed outside that box. In recognition of this fact, Canada and other relatively ‘open’ countries have in practice begun to delegate more and more elements of national tax authority to such informal internationally-dominated arenas as informal associations of tax administrators and policy makers. This is not a prescription; it is already reality, and likely to become even more so in the future. In the circumstances, perhaps the most important policy concern for those charged with shaping and implementing future tax policy should be to work towards more transparent and balanced *processes* to shape the international tax policy decisions that impact on and to some extent limit national tax policy autonomy.

Getting the right solutions from a domestic policy perspective with respect to such esoteric issues as controlled foreign companies, transfer pricing, thin capitalisation and the like is far too important for the development of coherent, feasible, and necessary domestic tax policy to be left to occasional informal chats in Paris or elsewhere. As with domestic tax policy, the ‘right’ results from a national perspective are only likely to emerge when the ‘right’ decision process is in place. It remains to be seen, however, whether that process will eventually lead to some form of ‘international tax organization’ or whether, as the experience of the European Union – which already faces all the problems discussed here in a particularly clear fashion – suggests, it may perhaps prove to be both more feasible and more probable that countries will not take pre-emptive action to ‘get it right’ but will instead wait until solutions of some sort finally seem to emerge from increasingly formal ‘joint’ policy actions and administrative cooperation between national administrations. Whichever route is followed, the formulation and implementation of tax policy in the future seems certain to become even more outward-looking than it already is. All those concerned with improving tax policy and sustaining the critical aspects of the existing public sector in open economies should be thinking more carefully about these matters than perhaps has been the case in the past.

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# The European Union constitution and the development of tax policy

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## **Abstract**

Taxation is an area of European Union (EU) policy in which the tension between subsidiarity and coordination is acute. This paper reviews recent EU policy alongside an analysis of the underlying economic issues. The governance of tax policy was one of the key issues that the proposed constitution for the EU was intended to resolve. The provisions of the constitution that was proposed in 2004 are assessed to determine whether they provided the powers that the EU requires to ensure efficiency. The changes proposed by the constitution are then compared to subsequent developments.

## **1. INTRODUCTION**

The Constitution for the European Union (EU) proposed in 2004 provided a clear vision for the future. It foresaw the Union as a single market with efficient trade and unhindered movement of capital and labour. Allied to this was the aim of balancing the freedom of competitive economic activity with support for the disadvantaged within a social market economy. The Constitution contained articles that provided a framework for the formulation of tax policy within the EU. The proposed Constitution was rejected in referenda in France and the Netherlands in May 2005, and consequently abandoned. It was replaced instead by the Lisbon Treaty of 2007 but this was far less visionary than the Constitution.

This paper considers recent developments in EU tax policy in the light of the proposed Constitution. We explore what was proposed for tax policy in the Constitution and then consider whether EU tax policy has followed the proposed developments regardless of the fact that the Constitution was not accepted. To explore what was proposed it is necessary to review and interpret individual articles of the Constitution and to describe the issues confronting EU tax policy.

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**Acknowledgements:** This paper was prepared for the Milan Political Economy Workshop on the European Constitution. We are grateful to Massimo Florio for the invitation to participate in the workshop and to participants for their comments upon the paper.

The major objectives of the Constitution were stated precisely in Article I-3:

The Union shall offer its citizens an area of freedom, security and justice without internal frontiers, and an internal market where competition is free and undistorted.

The Union shall work for [...] a highly competitive social market economy.

The Constitution also allowed for Member States to sustain a degree of independence in their policy choices. This was granted by the principle of subsidiarity which featured throughout the Constitution. For example, the intention of the Union to respect subsidiarity was promised in Article I-11:

The use of Union competencies is governed by the principles of subsidiarity and proportionality.

Even though the Constitution granted subsidiarity, it also envisaged some limits upon the application of this principle. These limits were also described in Article I-11:

Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and insofar as the objectives of the proposed actions cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

The drawback of subsidiarity is that individual Member States may make policy choices which are privately rational but not socially optimal. This is particularly relevant for tax policy given the incentives to engage in tax competition within a single market. To counteract this, the Constitution provided the EU with a coordinating role in policy. As set out in Article I-1:

The Union shall coordinate policies by which the Member States aim to achieve these objectives.

These clauses clearly set out the background against which tax policy was to be designed. Member states would have some subsidiarity but this would be limited by the need for coordination to ensure the efficient functioning of the single market. The rejection of the proposed constitution by voters in France and the Netherlands resulted in the withdrawal of the Constitution and, later, in its replacement by the Lisbon Treaty. What is clear is that if any constitution (or, possibly, any less formal set of new rules) is to be proposed in the future it must provide clear guidelines for trading subsidiarity against coordination. The same tensions between these two will arise in tax policy whatever the form of the final solution for the political structure of the EU. The need to address the divergence between the private and social benefits of the actions of Member States requires rules that permit a coordinating role for the Commission or its successor body.

In the context of tax policy there are a range of conflicts introduced by the multiple objectives of economic efficiency, sustaining a social market economy, and the maintenance of subsidiarity. The special feature that makes issues of governance so central is that tax policy bears directly on the efficiency of the single market and provides the revenue to finance social market activities. Taxation is also symbolic of the freedom of Member States to maintain independent control over a central

component of economic governance. The study of tax policy brings into stark focus how conflict can arise between the coordinating role of the Union and the rights of Member States to pursue their own distinguished policies under the principle of subsidiarity.

The paper begins by reviewing what was proposed in the Constitution about tax policy by assessing a number of its articles. The focus will be on how they could have been applied to provide remedies for the problems created by subsidiarity in a single market. The third section reviews the VAT harmonisation process that was begun by the EU in the late 1980s. This short history provides an illustration of many of the issues involved in tax governance. The remainder of the paper then focuses upon some of the further challenges facing the Union in connection with tax policy. The fourth section studies the taxation of commodities and links the issues surrounding subsidiarity with the principles of international taxation. The fifth section focuses on the taxation of capital as an example of the process of tax competition. The final section provides conclusions.

## **2. TAX POLICY UNDER THE PROPOSED CONSTITUTION**

The purpose of this section is to review the articles of the proposed Constitution which had significant bearing upon tax policy. In preparing these comments the wording of the Constitution has been taken literally, as opposed to trying to see through the wording to what might be implied.

The most fundamental requirements of economic activity were enshrined in Article I-4 which guaranteed:

The free movement of persons, services, goods and capital

and that:

Within the scope of the Constitution ... any discrimination on grounds of nationality shall be prohibited.

The need for free movement is fundamental to the development of the EU economy as a single market with a competitive basis and an efficient outcome. With taxation organized as at present, an increase in mobility is not without a cost since it necessarily enhances the incentive for Member States to engage in tax competition. As a consequence the EU will continue to face the prospect of tax competition undermining efficient tax policy if it does not revise its processes as mobility increases.

The articles committing to non-discrimination are interesting if they were applied to products in addition to people. One of the proposals that had been discussed in the EU for many years in connection with revised tax governance is the use of origin rather than destination taxation. However, the basis for the operation of an origin system is that it does discriminate between products on the grounds of nationality. That is, a product that is produced in several different Member States will be taxed at different rates in any country of final consumption.

This point can be emphasized by considering Article III-170 which dealt with the equal treatment of commodities in trade:

No Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products.

Where products are exported by a Member State to the territory of another Member state, any repayment of internal taxation shall not exceed the internal taxation imposed on them whether directly or indirectly.

Suppose a Member State wishes to use an origin subsidy on its product whereas other Member States employ a tax. Does the use of a zero tax class as an internal tax in excess of the subsidy on the domestic product? Is this discrimination because of nationality? This is a point where the equal-treatment principle may be in conflict with the wish to move to origin taxation.

The issue of the encouragement of mobility was repeated in several further Articles. In Article III-133 the right of workers to move freely was stressed:

Workers shall have the right to move freely within the Union.

More specific methods to achieve this mobility were described in Article III-136:

In the field of social security, European laws or framework laws shall establish such measures as are necessary to bring about freedom of movement for workers by making arrangements to secure for employed and self-employed migrant workers and their dependents:

- (a) aggregation, for the purpose of acquiring and retaining the right to benefit and of calculating the amount of benefit, of all periods taken into account under the laws of the different countries;
- (b) payment of benefits to persons resident in the territories of Member States.

The free movement of capital was also enshrined in two further Articles: first, by Article III-156:

Within the framework of this Section, restrictions both on the movement of capital and on payments between Member States and between Member States and third countries shall be prohibited.

Second, in Article III-157 the freedom of movement of capital was extended to movement between Member States and third countries:

The European Parliament and the Council shall endeavour to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to other provisions of the Constitution.

The implications of these articles for tax policy are clear. Increased mobility exacerbates the problems of tax competition. Increased mobility of capital places downward pressure on the corporate income tax rate. Increased mobility of labour puts similar pressure upon the income tax rate. Furthermore, increased mobility of labour plus entitlements to benefits exerts pressure on the welfare systems of Member States. These are the classic contributors to the race-to-the-bottom. Hence, if these Articles

had been applied here would have been a need for some offsetting policy intervention to control the effects that were likely as a consequence.

A theme that is repeated at several points in the Constitution is the role of policy coordination. Tax competition is a consequence of a lack of coordination in tax choice between countries. If Member States were to coordinate their policies then the externality would be internalized and efficient tax rates would be chosen. The statement of coordination in Article I-12 set out the basic requirement that Member States should coordinate:

The Member States shall coordinate their economic and employment policies within arrangements as determined by Part III, which the Union shall have competence to provide.

If fiscal policy is incorporated under the general heading of economic policy then this requirement to coordinate would have resolved the problem of tax competition. When this requirement is not sufficient, the Article provided the further authority for the Union to either ensure coordination or to take supplementary actions:

In certain areas and under the conditions laid down in the Constitution, the Union shall have competence to carry out actions to support, coordinate or supplement the actions of the Member States, without superseding their competence in these areas.

If tax policy had been included as one of the ‘certain areas’, this article would have opened a range of policy tools that could have been used to overcome the problem of independent tax setting. The simplest action would be coordination. Alternatively, supplementation of actions could have meant the direct redistribution of tax revenues between Member States or the imposition of equalization rules. Neither of these policies would supersede competence of the individual Member States since they would remain free to set their own tax rates. Instead, both would modify the relationship between instrument and outcome. As written, this article did not directly permit the EU to change the principle of taxation from destination to origin unless ‘support’ was given a very broad interpretation.

A more detailed and precise allocation of competence to the Union was noted in Article I-13. This article stated that:

The Union shall have exclusive competence in the following areas:

- (a) customs unions;
- (b) the establishing of the competition rules necessary for the functioning of the internal market;

These points were developed further in Article III-151:

The Union shall comprise a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect and the adoption of a common customs tariff in their relations with third countries.

Customs duties on imports and exports and charges having equivalent effect shall be prohibited between Member States. This prohibition shall also apply to customs duties of a fiscal nature.

The customs union statements are self-explanatory since the EU has long operated with a common external tariff and, since January 1993, as a single internal market. The second part was open to interpretation. The natural reading is that it referred to competition in the economic interaction of firms and consumers. This would continue the tradition of the EU in supporting an active competition policy operated for the benefit of consumers. There is, however, nothing to prevent the statement being interpreted as applying to competition at all levels of economic activity including competition between Member States in their formulation of fiscal policy. This was probably not intended when the Constitution was written but it is a legitimate interpretation. The competition rules would then have referred to the process of interaction between Member States and could have been used to introduce remedies to the tax cutting that is a consequence of the fundamentally oligopolistic behaviour in the tax game.

The issue of coordination arose again in Article I-15. The wording of this article suggested a greater degree of Union intervention and direction of policy:

Member States shall coordinate their economic policies within the Union. To this end the Council of Ministers shall adopt measures, in particular broad guidelines for these policies.

The use of 'broad guidelines' opened the possibility for a range of policy interventions at the EU level. The policy of harmonisation, which is discussed in more detail below, envisaged a gradually narrowing band of permissible tax rates until complete harmonisation had been achieved. The same method could be applied under this article to place upper and lower bounds on capital tax rates to lessen tax competition. It could also have been used to re-start the process for harmonisation.

Article III-179 expanded upon the coordination of policies and the fact that the effects of policies must be internalized. The claim to internalization comes from observation of the phrase 'common concern'. If internalized in this way it becomes immediate that some of the consequences of tax externalities between Member States would be reduced:

Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with Article III-178.

In order to ensure closer coordination of economic policies ... the Council ... shall monitor economic developments in each member state and in the Union, as well as the consistency of economic policies with the broad guidelines

When it is established ... that the economic policies of a Member state are not consistent with the broad guidelines ... or that they risk jeopardizing the proper functioning of economic and monetary union, the Commission may address a warning to the Member State concerned.

A further general provision to assist the functioning of the internal market could be found in Article III-130. This was concerned in general terms with the role of the EU in ensuring the functioning of the single market.

The Union shall adopt measures with the aim of establishing or ensuring the functioning of the internal market, in accordance with the relevant provisions of the constitution.

Since the structure of commodity taxation is so closely linked to the functioning of the internal market, this article can also be interpreted as having implications for tax policy. The continued existence of cross-border shopping caused by tax differentials involves a waste of economic resources and concurrent environmental damage cannot be viewed as a successful outcome of a functioning single market. If the EU wishes to have a single market where the patterns of trade are not distorted by taxation then this article provided a further basis upon which policy could be developed.

The final article to be considered dealt with the issue of harmonisation. The article referred to the harmonisation of legislation, not to the harmonisation of tax rates. There is, however, a question of how legislation can be interpreted. Article III-171 stated:

A European law or framework law of the Council shall establish measures for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation provided such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition. The Council shall act unanimously after consulting the European Parliament and the Economic and Social Committee.

Note that this statement explicitly referred to harmonisation to secure the efficient functioning of the market and to avoid distortion of competition. It has already been discussed how tax differentials lead to cross-border shopping which represents a distortion of trade.

With these elements of the proposed Constitution in mind we now discuss some of the major issues in EU tax policy. The articles in the Constitution can be viewed generally as continuing and developing long-standing policies. Even though the Constitution was never adopted it is clear that its intentions in the area of tax policy are slowly being realized.

### **3. THE SINGLE MARKET AND HARMONISATION**

The history of the tax harmonisation process undertaken by the Union from the late 1980s succinctly captures the key issues of tax governance. Reviewing the process reveals the tension between subsidiarity and efficiency, and between subsidiarity and coordination.

Harmonisation refers to the process of bringing about equality in the rate of VAT in Member States. It has been part of EU policy proposals since at least the Neumark Report (1963). The European Commission has understood that the single market implies a need for a degree of harmonisation of indirect taxes because of cross-border shopping and also because of potential protectionist use of national taxes. It is also concerned about the impact of different tax rates on mobile factors such as capital. Finally, certain countries are concerned about the possibility of 'tax evasion' being induced when countries retain autonomy over the setting of tax rates. The variation in

the tax treatment of income from interest on capital is a prime example. Harmonisation can also encourage trade by leading to simplified accounting.

The 1987 proposal on harmonisation was to restrict Member States to a two-rate system of VAT, a standard rate of 14 – 20% and a reduced rate of 4 – 9% for basic goods, combined with uniform excise duties. The proposal met with objections because of the substantial impact on some Members' tax revenues and the implications for tax rates on socially and distributionally-sensitive goods. Instead, a system of minimum tax rates was proposed in 1989 and introduced in 1993: a minimum standard rate of VAT of 15% and one or two lower rates of at least 5%, but the existing zero-rating as in the UK (of food, children's clothes) was allowed to continue, and a set of minimum excise rates was also proposed. The 'approximation' of tax rates remains a long-term goal.

Table 1<sup>3</sup> provides some data on the evolution of VAT rates in the Union since 1970. It can be seen from this data that little progress have been towards convergence until recently, when the Member States increased the rates in the last five years, which helped to overturn the falling trend in revenues during the global economic crisis. According to the Eurostat (2013), six Member States increased their standard VAT rates in 2009, eight in 2010, four in 2012, and nine in 2013, some after a temporary cut to boost demand.

**Table 1: VAT rates of EU member countries**

		Germany	France	Italy	UK	Denmark
1970-1974	Standard (normal)	11	23	12	10	15
	Reduced (essential)	5.5	7.5	6	-	-
	Increased (luxury)	-	33	18	-	-
1985-1990	Standard (normal)	14	18.6	19	15	22
	Reduced (essential)	7	2/7	4/9	0	-
	Increased (luxury)	-	23	38	-	-
2000	Standard (normal)	16	20.6	20	17.5	25
	Reduced (essential)	7	2.1/5.5	10	5	0

<sup>3</sup> Sources: Molle (2001); Eurostat (2013)



2013	Standard (normal)	19	19.6	22	20	25
	Reduced (essential)	7	5.5/7(2.1)	10/4	5	0

Variations in levels of excise duty and capital taxation in different EU Member States have also caused concern. As part of its internal market programme, the Commission also proposed the harmonisation of excise duties on mineral oils, tobacco products and alcoholic beverages. This was rejected by Member States, and a system of minimum rates was introduced in 1993. Despite this, as shown in Table 2<sup>4</sup> the dispersion of rates remains significant giving rise to substantial cross-border shopping flows.

**Table 2: Excise Taxes in euro, 1 July 2013**

	Cigarettes (per 100)	Wine (per litre)	Petrol (per litre)
Belgium	2.20	0.53	0.64
France	4.58	0.04	0.64
Germany	9.44	0.00	0.72
Spain	2.41	0.00	0.46
Sweden	16.64	2.55	0.76
UK	22.07	3.34	0.79

Given the high mobility of capital, differences in corporate tax rates (and systems) could result in significant distortions. In the face of hostility from Member States, however, the Commission has made virtually no attempt to harmonise corporate taxation (it largely ignored the recommendations of the Ruding Committee) limiting itself to measures that restrict double taxation. Tax competition has, however, resulted in some convergence of rates over the past decade. Some interpret this convergence as the process of tax competition succeeding in removing an economic distortion, others perceive it as a sign of a race-to-the-bottom.

Finally, Germany in particular has been concerned that a number of its citizens are evading taxes on their savings (or rather on the interest that they earn on these savings) by holding them in banks in other countries. It has pressed for the introduction of a common withholding tax on all interest paid on bank deposits and portfolio investments; this was supported by the Commission. This common withholding tax was opposed by other countries – most notably Britain, which saw it as threatening the City of London. At present, discussions continue on a hybrid system in which banks either withhold part of the income payable to non-residents or would provide information to the authorities in other Member States on how much interest has been paid and to whom. Less concern

<sup>4</sup> Source: EC Excise Duty Tables, Ref. 1038, rev. 1, available at [http://ec.europa.eu/taxation\\_customs/index\\_en.htm#](http://ec.europa.eu/taxation_customs/index_en.htm#)

has been shown over differences in personal income taxation. This is, perhaps, surprising since, together with social security contributions, personal income tax yields more than 40% of total tax receipts in the EU. The explanation can probably be found in the considerably lower mobility of labour compared to capital.

The EU position on harmonisation is captured in the following series of quotations. First, from the European Commission:

Member States have shown little enthusiasm for the proposals in Council meetings and [...] have been reluctant to accept the greater harmonisation of VAT rates and tax structures. (European Commission 2000, p18)

Second, from the 2003 Draft Report of the Committee on Monetary and Economic Affairs:

The European Parliament is strongly committed to the introduction of the definitive system of VAT, but given the lack of progress in that regard, there is no urgent need to harmonise rates.

Third, from the Council Directive of 2006:

It is ... necessary to achieve ... harmonisation of legislation on turnover taxes by means of a system of value added tax (VAT), such as will eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level. ... It is necessary to proceed by stages, since the harmonisation of turnover taxes leads in Member States to alterations in tax structure and appreciable consequences in the budgetary, economic and social fields. The common system of VAT should, even if rates and exemptions are not fully harmonised, result in neutrality in competition. ... It is vital to provide for a transitional period to allow national laws in specified fields to be gradually adapted. (Council Directive 2006/12/EC)

And, finally, from the Council Communication of 2011:

There is a general feeling amongst stakeholders that the fragmentation of the common EU VAT system into 27 national VAT systems is the main obstacle to efficient intra-EU trade and thus prevents citizens from reaping the benefits of a genuine single market. ... Divergent practices at national level are increasingly being highlighted as a frustrating burden. ... The economic evaluation concludes that compliance costs for businesses are high, with estimates ranging from 2% to as much as 8% of VAT collection. ... Reducing by 50% the dissimilarity of the VAT rates structure between Member States could yield a rise of 9.8% in intra-EU trade and an increase in real GDP of 1.1%. ... The application of the standard rate remains the basic principle and the VAT Directive does not compel Member States to make use of reduced rates. The Member States are therefore primarily responsible for limiting as far as possible the scope of such rates where they constitute an unjustified tax break. The current economic and financial context, which demands a strong fiscal consolidation of national budgets, is a further reason for limiting their use as compared to increasing the standard rates. (European Commission 2011)

It is clear from these quotes that the harmonisation of tax rates within the EU has returned to the policy agenda. The quotes show an acceptance of the fact that the process had reached a hiatus in the early 2000s, and the beginning of a new drive for harmonisation from the middle of the decade. It is also noteworthy that the basis of the argument has shifted over time. The final quote shows a change in focus from the rather tenuous concept of 'neutrality in competition' to a more concrete argument on compliance costs for businesses.

#### **4. THE TAXATION OF COMMODITIES**

The discussion of harmonisation has described some of the issues that the EU faces in connection with the taxation of commodities. Amongst these, it was noted that the system in use results in extensive cross-border shopping. That this would happen upon the completion of the single market was well understood at the time the policy was implemented. To counteract it the EU had the intention of significantly revising the system for commodity taxation. As will be described below, this intention has not yet been realized.

It is first interesting to discuss why cross-border shopping can be viewed as unwelcome since this is contrary to the view expressed in some publications of the EU (the report 'Unlocking the Potential of Cross Border Shopping in the EU' published in 2002 expresses dissatisfaction that over the survey period of a year only 13% of the EU population engaged in cross-border shopping). The explanation can be found in the different forms that such shopping takes. It is economically efficient for consumers to purchase from the cheapest source and in an economy without distortions this is a necessary condition for efficiency. From this perspective, cross-border shopping should be encouraged.

The view of cross-border shopping as a problem in the EU arises from the fact that the market is not undistorted. Instead, much cross-border shopping is driven by differentials in the tax treatment of commodities in different Member States. This is a case of one distortionary activity generating a further distortionary response which causes additional deadweight loss.

There are four routes through which cross-border shopping is damaging. First, there is a direct waste of resources if consumers undertake travel simply to exploit tax differentials. The private importation of commodities by consumers is less efficient because it cannot exploit the economies of scale enjoyed by transportation companies. Second, as well as the direct use of economic resources in inefficient transportation, private importing activity also imposes additional environmental costs. Third, cross-border shopping distorts the regional patterns of trade by encouraging the agglomeration of companies supplying the trade around border locations. Finally, the ability of governments to pursue independent objectives is undermined by the ability of consumers to employ cross-border shopping as a means of avoiding punitive taxation.

As an example of the final point, the UK government has long pursued a policy of imposing a high tax upon cigarettes to discourage consumption for health reasons. But if cigarettes can be purchased elsewhere in the EU with a lower rate of tax and personally imported back into the UK then, at best, the policy is only partially effective.

At worst, it simply becomes irrelevant.<sup>5</sup> In such cases, the perfectly acceptable objective of one Member State is undermined by cross-border shopping exploiting the tax choices of other Member States that do not subscribe to the same set of objectives.

The completion of the single market in January 1993 had a significant impact upon tax policy in the EU. Prior to the completion of the single market the system of taxation involved exports from one Member State to another being zero-rated. Importers paid VAT at the rate of the destination country in which final consumption would take place. For this system to work, the tax authorities had to be able to determine when goods crossed borders. This was possible using cargo manifests and other documents before 1993; but after that date, there was, in principle, supposed to be no difference between shipping goods from, for example, Milan to Munich and Milan to Manchester. The removal of borders ensured that there was no documentary trail on the basis of which tax liabilities could be determined.

The European Commission's White Paper of 1987 proposed that after the abolition of border controls Union procedures would mirror national ones. Exports would carry the VAT of the origin country, which could be reclaimed as input VAT in the destination country if the good was used as an input rather than a consumption good. The VAT charged to the final consumer would still be that of the destination country and a 'Clearing House' would reallocate revenues to the appropriate country. For example, a German firm buying a French product would reclaim French VAT contained in the price from the German Revenue Office and pay the German VAT on its sales instead. Since the importing country rather than the exporting country gives a credit for pre-paid VAT, a clearing mechanism would be necessary to redistribute the tax revenue between jurisdictions. The intention of the redistribution was to ensure that no major shifts in revenue occurred on the completion of the single market.

This proposal was never implemented because of the administrative problems which it would have generated. An interim scheme is currently in operation which attempts to mirror the pre-1993 zero-rating of exports. It does this by substituting accounts auditing for the role previously performed at frontier controls. It was initially foreseen that the interim procedure would be replaced by the 'definitive' system by 1997. This has still not happened. In fact, the nature of the definitive system has not yet even been determined and discussions about the future functioning of VAT continue.

The source of these problems is the method of taxation (or tax 'principle') employed by the EU. The form of taxation employed prior to the completion of the single market is known as the destination principle. Under this principle commodities are taxed in the country of final consumption. Exports are tax free, with taxes imposed once the border is crossed. Consequently, destination taxation requires the maintenance of borders so that the appropriate border tax adjustments can be made. The borders ensure that all commodities carry the tax rate of the country of consumption. This allows each country to pursue an independent tax policy, hindered only by the limited amount of smuggling that might take place. Under the destination principle with border controls, consumers cannot legitimately undertake cross-border shopping to exploit tax differentials.

The fact that the destination principle is not a suitable system of taxation for a single market was recognized at a very early point in the development of the EU. The

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<sup>5</sup> In 2005, in conjunction with HM Customs and Excise, a football club collected discarded cigarette packets after a match. 22% were found to have been unofficially imported.

Tinbergen Report of 1953 prepared for the European Coal and Steel Community recognized that destination taxation would not be sustainable once the single market was completed. This implied a choice between either accepting an outcome with cross-border shopping exploiting tax differentials, placing limits on the possible differentiation of tax rates between Member States, or the replacement of the destination principle with an alternative system of taxation.

The alternative system of taxation proposed by Tinbergen (1953) was the origin principle which taxes goods in the country of production. In brief, under the origin principle a good is taxed by the country in which final production takes place prior to supply to consumers. When applied to the Union, the origin principle would require each Member State to tax the production occurring within its borders. Products produced by one Member State would bear the same rate of tax regardless of where they were consumed in the EU. The advantage of the origin principle is that no border tax adjustments are required so that it is consistent with the operation of a single market (in that tax differentials do not induce cross-border shopping) and it leaves each Member State free to pursue its own tax objectives.

The switch to the origin principle of taxation has long been established as a goal of Union tax policy. A statement of support for this position was contained in Amendment 2, Recital 5 of the 2003 Draft Report of the Committee on Monetary and Economic Affairs. The relevant passage states that:

The Community's long term objective is moving to a definitive VAT system, based on the principle of taxation in the country of origin; this implies that there should be a gradual continuation of a systematic and coherent approach towards approximation of VAT rates, as needed.

The Council Directive 2006/112/EC mentions the destination principle as the one that should be used during the transition to the harmonised system of VAT. More recently, however, the Communication on the future of VAT (European Commission 2011) has admitted that the origin principle

remains politically unachievable. This deadlock is even recognized by the European Parliament - until now a fierce defender of the principle of origin - which has called for a move towards the destination principle.

Many economists since Tinbergen have argued for a switch to the origin principle (for example, Lockwood et al., 1994, 1995) in preference to remaining with a destination system that is inappropriate. One argument that might be thought to have held back the EU in making the change is that a transition in the basis of taxation, from taxing consumption to taxation production, would cause a major disruption in revenues. This need not be so. Support for this statement is derived from the equivalence results which demonstrate (with uniform taxation of commodities) that the destination principle with border controls leads exactly to the same economic outcome as the origin principle without.

In a closed economy this result is easy to understand. The levels of production and consumption in equilibrium must be equal, so the change in the principle has no effect upon the size of the tax base. If the tax rates are the same under the two principles they must lead to the same relative prices and, hence, to the same equilibrium. In an open economy the change in the principle must cause the relative tax rates on different goods

to change. For example, if the one country has a lower rate of VAT than a trading partner then imported goods will bear a higher rate of tax after the switch. However, this change in relative taxes between the two principles is compensated for by adjustment in the relative wage rates in the trading countries. Even more surprising, if tax rates are not uniform within each country then the origin principle may even lead to higher economic welfare than the destination principle (Keen and Lahiri 1998; Hashimzade et al. 2005).

This literature suggests that a switch from destination taxation to origin taxation is feasible without major changes in tax revenues and more than likely would be beneficial. In particular, the effects of the switch would be minimized if undertaken once the labour market is liberalized.

As was discussed above, the Constitution that was proposed did not explicitly enter into a prescription of the future system of taxation. What it did provide was a statement of what the EU wished to achieve and the powers that it would have to achieve it. Until a Constitution is adopted, or other set of definitive rules implemented, the EU will remain in the current unsatisfactory position. For now, however, the switch to the origin principle appears to have been removed from the agenda, in favour of a 'simpler, more efficient and robust VAT system' based on the destination principle. As stated in the Communication of the European Commission on the future of VAT,

The Commission has come to the conclusion that there are no longer any valid reasons for keeping this objective, and will propose that it should be abandoned. ... Abandoning the origin principle makes it possible to launch substantial efforts to devise alternative concepts for a properly functioning destination-based EU system of VAT. (European Commission 2011)

## 5. CAPITAL TAXATION AND TAX COMPETITION

The discussion of commodity taxation has focussed upon the choice of the tax principle and whether tax rates should be harmonised. In contrast, the discussion of capital taxation in the context of the Union has emphasized the consequences of jurisdictions competing for mobile capital by strategically setting their tax rates. Such competition can lead to inefficiently low tax rates and can even culminate in the 'race-to-the-bottom'.

The serious economic analysis of tax competition began in Mintz and Tulkens (1986) and Wildasin (1988). The extensive literature that has developed since is surveyed in Wildasin (1999). The basic source of tax competition is that an increase in the rate of tax on corporate income by one Member State will lead to a capital outflow to other Member States. This raises the tax revenue of the other Member States so that there is a positive tax externality and, as expected with a positive externality, equilibrium tax rates will be too low.

The more extreme versions of this argument see Member States engaged in a 'race-to-the-bottom' in which a succession of tax cuts driven by tax competition gradually erode government revenues. The lack of revenue then prevents the governments from financing desirable social policies. The extreme versions of this scenario see tax competition undermining the entire basis of the social market economy envisaged by the new Constitution. A particularly strong expression of this argument can be found in Sinn (2002).

The paradox facing the EU is that the free movement of capital and labour is necessary to achieve economic efficiency within the single market, yet it is these factors that give rise to tax competition. It might be thought that some hope for the EU could be obtained by appealing to the Tiebout hypothesis (Tiebout 1956) which claims that competition between jurisdictions will lead to the founding of a range of heterogeneous jurisdictions that ideally meet the needs of all members of the population. Whether this holds in practice has long been a contentious issue, although evidence from US data does offer some support for the hypothesis (Rhode and Strumpf 2003). Even so, it is unlikely to be true for the EU, given that the EU contains only a small number of Member States, thus preventing application of the hypothesis.

As well as reducing equilibrium tax rates, tax competition can also limit the scope of redistribution. In the economic analysis it is assumed that individuals relocate to seek the best benefits package obtainable. Any government that attempts to imply redistribution will attract recipients and drive away contributors. The government is then forced to cut benefits, so as not to attract a population of a type it cannot afford. As Hindriks (1999) has shown, this process results in less redistribution in equilibrium than jurisdictions wish to have. This reduction in redistribution may be offset by the emergence of endogenous transfers between jurisdictions that offset the externality (Hindriks and Myles 2003). Intriguingly, the structure of these transfers demonstrates the characteristics of the reallocation of own resources in the EU. In any case, there remains a beneficial coordinating role for a central authority.

In addition to the direct effect upon tax revenue, there are several further reasons why the level of corporate taxation matters. Taxes determine the return on corporate assets and so affect the decisions of firms to invest and the portfolio allocation of financial resources across assets. If there is variation in the tax rates of Member States for reasons of tax competition, then these decisions will not be made efficiently. Variation in tax rates can also be exploited by the internal accounting of firms to manipulate the allocation of profit across Member States to minimize tax liabilities. Tax rates can also influence the choice of plant location for companies with the possible introduction of long-term inefficiency.

Evidence on the extent of tax competition is contained in the OECD report of 1998. It can also be witnessed in the data on corporate tax rates of EU Member States. A sample of this evidence is reported in Table 3<sup>6</sup> which details the statutory corporate income tax rate in 1982, 2001, and 2013. In all countries, with the exception of Italy and Ireland, the statutory tax rate has fallen, in some cases dramatically. These reductions are usually interpreted as being driven by the success of the low rate of corporate tax introduced in Ireland.

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<sup>6</sup> Sources: Devereux et al. (2002); Taxation Trends (2013).

**Table 3: Adjusted top statutory tax rate on corporate income, in per cent**

	1995	2001	2013
Austria	61	34	25
Belgium	45	40	34
Finland	50	35	36
Germany	62	38	30
Greece	42	38	26
Ireland	12.5	12.5	12.5
Italy	38	40	31
Netherlands	48	35	25
Portugal	55	36	32
Sweden	61	28	22
UK	53	30	23

The evidence in Table 3 provides an indication of the direction of change in tax rates but it does not provide the complete picture. The data in Table 3 is for the statutory rate which is the value set in legislation. In most countries tax legislation also includes a series of reductions, exemptions and relief for capital investment. The rigor of enforcement is also variable. It is therefore quite possible that a reduction in the statutory rate can be offset by a broadening of the tax base through a reduction in exemptions. Such broadening can offset the effect of the rate reduction upon revenue.

Some evidence of the net effect of rate reduction and base broadening is presented in Figure 1.<sup>7</sup> This figure graphs the revenue from corporate taxation as a percentage of GDP for 27 EU member economies and separately for the UK. The reason why the UK data may be particularly interesting is the argument that tax competition in the Union has been driven by the aggressively low rate of tax in Ireland. The UK is Ireland's closest geographical neighbour and shares a common language. It is natural to expect that if the low tax rate has benefited Ireland then it will have done so at the expense of lost capital for the UK. For the aggregate curve the percentage value for each country is weighted by GDP, so that the effect in small countries cannot dominate the overall picture.

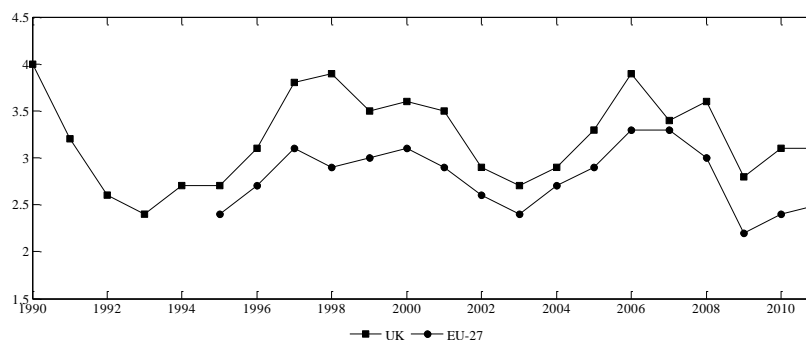
Contrary to the evidence from looking at the statutory rate, revenue from the corporate income tax remained mostly constant until the early 1990s and has shown a strong growth trend over the following 10 years. While an increase in corporate profitability

<sup>7</sup> Data source: Taxation Trends (2013).



may explain at least some of this increase, the fact remains that revenues from the corporate income tax are not being adversely affected by the effects of tax competition.

**Figure 1:** Corporate Income Tax Revenue as a Percentage of GDP.



There has been a weak trend for a decrease in revenue through the late 1990s and early 2000s, but this has been clearly driven by changes in corporate profitability. From 2003 revenues were on a rising trend which has resumed after a short dip during the economic and financial crisis in 2007-8. It might be expected that if tax competition is driving down capital tax rates, the process would have accelerated since the completion of the single market in December 1992. To test this idea, consider the data in Figure 1: it can be seen that the effective burden on capital has actually risen very slightly since 1993 – the converse of what the tax competition argument would suggest. If the Member States are engaged in tax competition then it is not necessarily leading to the collapse of revenues even for the countries that may be expected to suffer the most.

The current policy of the EU towards tax competition is encapsulated in the Code of Conduct for Business Taxation. The Union's Finance Ministers established the Code of Conduct Group (Business Taxation) at a Council meeting on 9 March 1998. The Code is not a legally binding instrument but it clearly does have political force. The Code of Conduct requires that Member States refrain from introducing any new tax measures that may be harmful ('standstill') and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code ('rollback'). The Code covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on corporate location decisions within the EU.

There are a range of criteria for identifying potentially harmful measures. The first of these is the use of an effective level of taxation which is significantly lower than the general level of taxation in the country concerned. Similarly, the Code identifies as harmful any tax benefits reserved for non-residents. Both of these measures influence the location decision of a corporation. In addition to these, other measures judged as harmful are tax incentives for activities which are isolated from the domestic economy and, therefore, have no impact on the national tax base, and the granting of tax advantages even in the absence of any real economic activity. The Code also requires that accepted accounting conventions are adhered to, with it judged harmful if the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD. Finally, a lack of transparency in the tax treatment of corporations is also judged harmful.

Economists have identified tax competition as harmful because it leads to equilibrium rates of tax which are below the efficient level. In turn, the low tax rates lead to reduced government revenues, thus limiting the scope for redistributive social policies. The mobility of labour can also undermine an attempt to conduct redistributive policy. Observation of the fall in statutory corporate income tax rates is usually given as evidence of tax competition within the EU. A review of the data shows that corporate tax revenues as a percentage of GDP have not fallen. This can occur through the tax-base broadening and through an increase in corporate profitability. More recently, however, concerns about decreasing competitiveness in the wake of the economic and financial crisis led to a trend in the tax reforms in the EU Member States mostly introducing tax-base-narrowing measures. At the same time some Member States have broadened their corporate tax bases by limiting interest deductibility and by restricting loss relief (Tax Reforms in the EU Member States 2013). The EU has a voluntary Code of Conduct designed to lessen tax competition. As was noted above, the proposed Constitution granted the EU powers to coordinate the policies of individual Member States. Coordination is the natural policy to combat tax competition.

## 6. CONCLUSIONS

The central economic aspirations of the European Union are to attain the objective of a highly competitive social market economy. At the same time it also wishes to respect subsidiarity and allow Member States to pursue independent policies. In the area of tax policy these two aims come into conflict as exemplified by the race-to-the-bottom that has often been predicted as the inevitable consequence of tax competition. The paper has explored how the proposed Constitution for the EU planned to deal with these difficulties. The articles of the Constitution suggest an intention to restart the process of harmonisation and to enhance coordination of tax policy.

The history of tax harmonisation in the EU reveals a policy that has gradually eroded the ability of individual Member States to set their own tax rates. Although harmonisation would have removed many of the problems brought about by tax differentials between Member States it was eventually abandoned because of opposition caused by the perception that harmonisation was threatening subsidiarity. Even without an explicit process for harmonisation the data reveal that it has nonetheless happened with the differential between the lowest and highest standard VAT rates diminishing over time. The choice of a tax principle for the EU has made even less progress than that of harmonisation. If the EU cannot harmonise the rates then an alternative would be to switch to origin taxation. This possibility has been discussed in EU policy debate since the time of the Treaty of Rome. Origin taxation has also been adopted as a proposal for the EU, although there is considerable debate about the precise form the system will take. However, there appears to have been no progress on this issue at all since the Constitution was proposed. Competition between member states in the setting of tax rates on corporate income has led to a fall in statutory tax rates but also to changes in the tax base. The policy to counter this has so far been restricted to the adoption of a Code of Conduct rather than a set of formal policy regulations. This is unlikely to prove sufficient to control the competition if the gains from violation are sufficiently large.

The proposed Constitution reaffirmed the commitment of the EU to the freedom of movement for capital and labour with an absence of discrimination. The Constitution also perceived a role for the EU to play in the coordination of the policies of Member States. Given that the aims of efficiency, freedom of movement, and subsidiarity lead

to the problems outlined above, the EU clearly needs to exercise a coordinating role in the area of taxation. Although the Constitution also required Member States to take account of the effect of their policies on others, thereby internalizing, at least partially, some of the externalities, it still left an important role for the Commission to play.

In principle, the articles of the proposed Constitution would have granted to the EU the powers required to control tax policy and to achieve the economic efficiency it pursues. Whether this would have been the case in practice depends on how arguments over subsidiarity and coordination would have been resolved. The proposed Constitution sought to provide the necessary balance between subsidiarity and coordination but, as is often the case with the EU, the actual outcome would have emerged as a compromise from political negotiation. From the perspective of tax policy the proposed Constitution can be judged to have reached many of the correct conclusions. Any future set of rules for the EU must achieve a very similar compromise.

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# Far east tax policy lessons: good and bad stories from Hong Kong

Richard Cullen<sup>1</sup>

## **Abstract**

Some claim that Hong Kong is a remarkable tax policy museum while others say it is a centre of tax policy innovation – who is right? In fact, both views are credible. In both cases, these outcomes are the product of a near continuous economic dialectic - and happenstance - set within a particularly relevant culture. Textbook policy planning has provided after-the-fact rationales far more than it has generated future policy blueprints.

This article explains why the Hong Kong Revenue Regime (RR) has such a museum feel. And also how this ‘arrested development’ has produced an ‘innovative system’. The innovation is unorthodox but real enough. Compared to most other developed jurisdictions, it has involved, above all, applying an instinctive version of ‘Occam’s Razor’ to system review and development: reform has been kept to the bare minimum. Hong Kong thus retains an RR which is (formally) low tax, clearly simple (with low compliance costs) and it has generated revenues sufficient to build excellent infrastructure, to provide often first rate government services, to enable Hong Kong to stay virtually debt free and to amass huge Fiscal Reserves. All of these achievements pivot, fundamentally, on Hong Kong’s remarkable, long-term (and continuing) reliance on significant, land-based funding of public revenue. It also offers potentially important revenue policy lessons for application beyond Hong Kong – at least, where this may still be politically possible.

But how about the bad stories? First, the cost of doing anything in Hong Kong is notably inflated by the very high cost of land – ultimately provided by a de facto monopoly supplier: the Hong Kong Government. Further examples: the poverty gap is far wider than it should be; and planning to cope with the onset of major demographic changes is poor. This paper will clarify how the success of the RR, together with other important factors, continues to underpin unacceptable policy inflexibility.

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## 1. INTRODUCTION

One can reasonably claim that Hong Kong is a remarkable tax policy museum and also argue that has been a centre of revenue policy innovation.<sup>2</sup> In both cases, these outcomes are the product of a near continuous economic dialectic - and happenstance - set within a particularly relevant culture.<sup>3</sup>

The innovative aspects of revenue policy making in Hong Kong are essentially the result of decades of try-it, test-it and (mostly) retain-it experience set against a remarkable history of dynamic trading and much political turbulence, including outright war. Text book policy planning has provided after-the-fact rationales rather more than it has generated future policy blueprints.

The innovation, above all, has pivoted on successfully accessing non-usual sources of public revenue. This has allowed for the application, from the creation of British Hong Kong (in 1842) to the present day, of an instinctive version of ‘Occam’s Razor’ to system review and development: reform has been kept to the bare minimum.<sup>4</sup> Hong Kong thus retains a Revenue Regime (RR) which is (formally) low tax, clearly simple (with low compliance costs) and it has generated revenues (within the special and relevant features of Hong Kong society) sufficient to build excellent infrastructure, to

<sup>2</sup> Hong Kong has consistently used British terminology to describe its public revenue system, thus the primary taxation statute is the Inland Revenue Ordinance (1947). One usually talks of the revenue regime and revenue policy (although the terms tax system and tax policy are also used). As we will see, the varied sources of public revenues which are not, in fact, taxes make this British terminology more apt, overall.

<sup>3</sup> Hong Kong’s population is over 90% Chinese, which is predominantly post-war, migrant-based. Hong Kong consists of Hong Kong Island, the Kowloon Peninsula situated on the Mainland opposite Hong Kong Island, the New Territories comprising the area north of Kowloon up to the Shenzhen River and 235 islands. Hong Kong Island was ceded in perpetuity to Britain by China in 1842 at the end of the First Opium War (1839-1842) pursuant to the Treaty of Nanking (Nanjing). The Kowloon Peninsula was ceded in perpetuity in 1860 at the end of the Second Opium War (1856-1860) under the Convention of Peking (Beijing). The New Territories and the islands were leased for 99 years from 1 July 1898 under the Convention Respecting the Extension of Hong Kong Territory. The Hong Kong Special Administrative Region (HKSAR) was established in accordance with the Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People’s Republic of China (PRC) on the Question of Hong Kong (Joint Declaration) signed on 19 December 1984. The PRC said in the Joint Declaration that it had decided to resume the exercise of sovereignty over Hong Kong (the leased territories, together with Hong Kong Island and Kowloon) with effect from 1 July 1997. The UK declared that it would restore Hong Kong to the PRC with effect from 1 July 1997. The Joint Declaration entered into force on 27 May 1985 when the two governments exchanged instruments of ratification. It was registered as a treaty at the United Nations by the Chinese and British governments on 12 June 1985, which creates international rights and obligations for both parties. The Basic Law of the HKSAR of the PRC (Basic Law) was adopted by the National People’s Congress of the PRC on 4 April 1990 and came into force on 1 July 1997. The HKSAR Court of Final Appeal, the pinnacle of the judicial process (which is entirely separate, under the Basic Law) found, in 1999, that the Basic Law enjoyed constitutional status within the HKSAR (Ng Kar Ling & Others v. Director of Immigration [1991] 1 Hong Kong Law Reports & Digest, 315). For a detailed discussion on these historical, political developments within the context the evolution of the British Hong Kong RR, see, Cullen, Richard and Wong, Antonietta, ‘How History has Shaped the Hong Kong Revenue Regime’ in (Sharkey, Nolan (ed.)) *Taxation in ASEAN and China* (Routledge, Abingdon, 2012). See, also, Ghai, Yash, *Hong Kong’s New Constitutional Order* (2nd ed.) (Hong Kong University Press, Hong Kong, 1999).

<sup>4</sup> The test associated with William of Occam (1285 – 1349 AD) is commonly rendered as: *Pluralitas non est ponenda sine neccesitate* or ‘plurality should not be posited without necessity’. See, further, Occam’s Razor, at: <http://www.skepdic.com/occam.html>.

provide often first rate government services, to enable Hong Kong to stay virtually debt free and to amass huge Fiscal Reserves.

The bad stories are striking, also. The very success of the RR, together with other important factors, have helped entrench what today, more than ever, is an unacceptable level of revenue policy inflexibility. The poverty gap is far wider than it should be; and (revenue policy) planning to cope with the onset of major demographic changes is poor. Moreover, the cost of doing anything in Hong Kong is notably inflated by the very high cost of land – ultimately provided by a de facto monopoly supplier: the Hong Kong Government.

The next Part of the paper reviews the origins of revenue policy making in British Hong Kong. Part 3 provides a brief operating profile of the current RR. Part 4 moves on to consider the key policy lessons which can be drawn from the Hong Kong experience. I argue that these lessons are both important for Hong Kong and also more widely. Part 5 is the Conclusion, where the potential wider relevance of certain positive lessons to be drawn from the Hong Kong Revenue Policy experience is explored, not least for the People's Republic of China (PRC).

## 2. 'BLACK CAT-WHITE CAT'. THE ORIGINS OF REVENUE POLICY IN HONG KONG

It is claimed that in 1962, the later Paramount Leader (1978 – 1992) of China, Deng Xiaoping first used the expression *Buguan bai mao, hei mao, lizhu laoshu jiu shi hao mao*, often translated as, *It doesn't matter if the cat is black or white, so long as it catches mice*. The expression was apparently borrowed by Deng from a farmer in Anhui Province. It was deployed to try and steer public policy in the People's Republic of China (PRC) back towards comprehensive, economic pragmatism.<sup>5</sup> As we review the development of the RR in Hong Kong from 1842, it is fair to say that the British look to have relied on an early, occidental variant of this dictum.

A heavy dependence on land-related revenues (wherever possible) within the British Colonies was well established as a key public finance measure by the early 19<sup>th</sup> century. In essence, this approach sought to fund the running of many British Colonies by relying, primarily or significantly, on the disposal of (appropriated or discount-purchased) Crown land by Colonial Governments.<sup>6</sup> It appears the policy was developed in London through the Colonial Office in response to the unhappy outcome arising from

<sup>5</sup> Li, Kwok-sing (trans. Mary Li), *A Glossary of Political Terms in the People's Republic of China* (Chinese University Press, Hong Kong, 1995) 13. Available at Google Books: [http://books.google.com.hk/books?id=J5QbQpQTegwC&pg=PA13&lpg=PA13&dq=black+cat+white+cat+china&source=bl&ots=qoDM11-vm4&sig=Iqsg5cq2fDTf\\_zUCkGipyr8waLo&hl=en&sa=X&ei=Rg9yUafICbG8iAeTooCYCw&ved=0CGMQ6AEwBw#v=onepage&q=black%20cat%20white%20cat%20china&f=false](http://books.google.com.hk/books?id=J5QbQpQTegwC&pg=PA13&lpg=PA13&dq=black+cat+white+cat+china&source=bl&ots=qoDM11-vm4&sig=Iqsg5cq2fDTf_zUCkGipyr8waLo&hl=en&sa=X&ei=Rg9yUafICbG8iAeTooCYCw&ved=0CGMQ6AEwBw#v=onepage&q=black%20cat%20white%20cat%20china&f=false). (As with many such sayings, whether they were actually uttered by the claimed person (and when) gives rise to plentiful disputation).

<sup>6</sup> See: Hooper, Keith C., *Substance but not Form: Capital Taxation and Public Finance in New Zealand* (1840 – 1859) at: [www.findarticles.com/p/articles/mi\\_qa3933/is\\_200311/ai\\_/](http://www.findarticles.com/p/articles/mi_qa3933/is_200311/ai_/); and, Harris, R. Cole, *Making Native Space: Colonialism, Resistance and Reserves in British Columbia* (University of British Columbia Press, Vancouver, 2002) Chapter 1. See, also, Pierce, Steven. *Farmers and the State in Colonial Kano: Land Tenure and the Legal Imagination*. (Indiana University Press, Bloomington, 2005).



attempting to impose long-distance, London-devised costs and taxes in the British–American Colonies in the second half of the 18<sup>th</sup> century.<sup>7</sup>

From a London point of view, these long-distance imposts were originally seen to be necessary to help cover local colonial expenditure in America on, for example, maintaining local military garrisons and the provision of public infrastructure in the American Colonies. This approach, *inter alia*, culminated in the loss of those colonies and the establishment of the USA.<sup>8</sup>

Another feature of colonial financing within the British Empire was a general avoidance of direct taxes (on, for example, salary, wages, profits or rents). This was especially the case in the smaller British Crown Colonies (such as Hong Kong).<sup>9</sup> It was felt that such taxes required an element of understanding as to why they were needed on the part of the individuals subject to said taxes and this understanding was usually widely lacking.<sup>10</sup> This meant that there was a strong preference for collecting revenue from indirect taxes (for example, Customs Duties, Excise Duties) business licence fees, certain specific taxes (for example, Stamp Duties) – and from land sales and land usage charges.<sup>11</sup>

Ideally, these post American Revolutionary War, British colonial revenue systems were meant to be: colony-confined (no extra-territorial taxation); self supporting (but not ‘Mother-Country’ supporting); and crafted to suit the local political-economy.<sup>12</sup> Where the ‘chief economic consideration’ of a colony was trade with foreign countries then, it was argued, all trade-related taxes (especially, Import Duties) should be kept very low or be non-existent. In some colonies (in Africa and the Pacific) poll taxes were used, also.<sup>13</sup> As various British Colonies developed more sophisticated economies – including more taxpayers blessed with a capacity to ‘understand’ – a greater use of income-type (direct) taxes began to be imposed.<sup>14</sup>

By 1890, 55% of China's imports and 37% of Chinese exports passed through Hong Kong.<sup>15</sup> Over the first 50 years, economic growth in British Hong Kong was, in sum,

<sup>7</sup> The position of Secretary of State for the Colonies was first established in 1768 in response to restiveness in the American Colonies. By 1801, after the loss of those colonies a new position of Secretary of State for War and the Colonies was established. In 1854 a fully separate Colonial Office was established under the now Secretary of State for the Colonies. See, Secretary of State for the Colonies, at: [http://en.wikipedia.org/wiki/Secretary\\_of\\_State\\_for\\_the\\_Colonies](http://en.wikipedia.org/wiki/Secretary_of_State_for_the_Colonies).

<sup>8</sup> See, American History Series: Britain Says No to 'No Taxation Without Representation', at: <http://www.voanews.com/specialenglish/archive/2007-12/2007-12-05-voa2.cfm>.

<sup>9</sup> Reinsch, Paul S. *Colonial Administration* (MacMillan, London, 1912), 92ff (Available at: <http://books.google.com/books?id=uZJKdzOZ0pAC&pg=PA98&lpg=PA81&dq=colonial+taxation&output=html&sig=80hpdTPdUtPuIQH1bClQdH57BQY>).

<sup>10</sup> *Ibid.*

<sup>11</sup> *Ibid.*

<sup>12</sup> *Ibid.*

<sup>13</sup> Eichelgrun, G., ‘Income-Tax in British Colonies’ (1948) 58 *The Economic Journal*, 128.

<sup>14</sup> By 1922, an Inter-Departmental-Committee in London had devised a ‘Model Ordinance’ for imposing Income Tax. This Model Ordinance drew on older precedents developed within the Australian and New Zealand colonies together with more recent laws from Canada and Australia. *Ibid.*

<sup>15</sup> Rating and Valuation Department of the Hong Kong Special Administrative Region, *A Chronology of Events*, at: [http://www.rvd.gov.hk/en/publications/chron\\_events.htm](http://www.rvd.gov.hk/en/publications/chron_events.htm).

notably impressive. As in the case of another key East Asian, British Empire City-State, Singapore, a foundation stone of this economic success was the trade in opium.<sup>16</sup>

Despite this huge growth in trade, especially in the opium trade, and Hong Kong's pivotal role, the Hong Kong government battled with only limited success for several decades to use opium-based transactions as a primary if not the primary source of public revenue for the new colony. This lack of success seemed odd given the comparative ease with which Singapore (and other colonial outposts in East Asia) had been able to deploy an officially-sanctioned opium monopoly regime to raise very significant public revenues.<sup>17</sup>

It is true that, as Hong Kong was declared a Free Port from the outset of its founding, there was no way to derive revenue from the import-export trading activities in opium (or other goods). But this restriction also applied to Singapore. Arguably the most credible explanation advanced for this interesting discrepancy is that the British administration in Singapore, at its founding as a British Colony, was able to work with certain established Chinese trading elites who could see the benefits of running the new 'opium farm' over the longer term.<sup>18</sup> In Hong Kong, at the same point in its history, there were, it appears, no similarly (long-term) motivated elite groups with which to work.<sup>19</sup>

From its inception, British Hong Kong did not allow (virtually) any sale of freehold land.<sup>20</sup> All land was made available as leasehold land (with strict conditions attached to each particular leasehold-usage). And landholders wishing to vary the usage allowed on a particular lease had, on each such occasion, to pay a premium to the Hong Kong government to secure the variation.

Moreover, the practice grew of restricting the availability of land for development. This tended to drive up the price of land (towards the upper limits of what the market would accept) and also revenue receipts.<sup>21</sup> When one factored in the consistent strong, opium-

<sup>16</sup> See, for example: La Motte, Ellen N., *The Opium Monopoly* (MacMillan, New York, 1920) at: <http://www.druglibrary.org/schaffer/history/om/om15.htm>; and Feige, C. and Miron, J. A. 'The Opium Wars, Opium Legalization, and Opium Consumption in China' at: [http://www.economics.harvard.edu/faculty/miron/files/opiumwars\\_ael.pdf](http://www.economics.harvard.edu/faculty/miron/files/opiumwars_ael.pdf).

<sup>17</sup> A detailed review of the (eventual) development of direct, opium-related revenues as a prime source of public funding in British Hong Kong can be found in Cullen and Tso, op. cit. note 1.

<sup>18</sup> Today the term used would be an 'opium franchise'. The term farm did not, of course, refer to some sort of horticultural farm. Rather the term indicated a 'farming out' of the right to retail opium.

<sup>19</sup> Munn, Christopher, 'The Hong Kong Opium Revenue 1845-1885' in (Brook & Wakabayashi, (eds.)) *Opium Regimes: China, Britain and Japan, 1839-1952* (University of California Press, Berkeley, 2000).

<sup>20</sup> The Hong Kong Anglican Cathedral occupies freehold land. Landholders in the New Territories have also historically been allowed, by the government, to enjoy certain special rights to land based on ancestral rights which derive from membership of long established communities in the New Territories. See, Nissim, Roger, *Land Administration and Practice in Hong Kong* (2nd. Ed.) (Hong Kong University Press, Hong Kong, 2008).

<sup>21</sup> In 1995/96, during the last years of British rule, the Hong Kong government still derived some 32% of total revenues from land-related transactions (including sales, lease modification premiums and Stamp Duties – but not including Profits Tax and Salaries Tax arising directly from the real estate sector) see, Loh, Christine, *The Government's High-Land-Price Policy: Can Hong Kong People Afford it?* at: <http://www.citizensparty.org/housing/landpric.html>. See, too, Bell, D.A., *Hong Kong's Transition to Capitalism* at: [http://www.findarticles.com/p/articles/mi\\_qa3745/is\\_199801/ai\\_n8787332](http://www.findarticles.com/p/articles/mi_qa3745/is_199801/ai_n8787332). When one adds in the Profits Tax paid by developers and all the others involved in construction, transaction based Stamp Duties and Salaries Tax paid by those working in the sector, the HKSAR government has continued to rely on land transaction related revenues for around 50% of its income, see, Halkyard,

based, growth in the economy over the first 50 years, the Hong Kong government found that its land-based revenue regime more than compensated for the shortfall in expected funding from the opium-based revenue stream. Indeed, the colony's fiscal foundations proved to be so sturdy that, within around 40 years of its founding, the Hong Kong government had already amassed more than one year of total, normal, public expenditure in Fiscal Reserves.<sup>22</sup>

This land-related revenue regime was further strengthened as the total area comprising the Crown Colony increased significantly, initially in 1860 and then in 1898. The expansion of Hong Kong increased the Hong Kong government's 'land-bank' greatly.<sup>23</sup>

In 1945, following the political, personal and economic devastation of Japanese occupation during the war, Hong Kong's per capita Gross Domestic Product (GDP) was, by some estimates, lower than that of India and Kenya.<sup>24</sup> By 1992, Hong Kong's per capita GDP had overtaken that of the UK. By 2004, Hong Kong was ranked at 23 in a global, 'highest GDP per head' table, ahead of Canada and Australia.<sup>25</sup> The HKSAR now ranks 5<sup>th</sup> according to recent World Bank and IMF GDP per capita tables.<sup>26</sup>

Wealth distribution in Hong Kong remains very uneven; significant poverty persists. But there is no denying that the British City-State materially transformed itself over the

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Andrew, 'The Hong Kong Tax Paradox' (1998) *Revenue Law Journal*, 1. This heavy reliance on land transaction revenues in Hong Kong bears some resemblance to the theories propagated by Henry George, the 19th century American economist and social reformer who long advocated the introduction of a single tax on the unimproved value of all land to replace all other taxes. See: Smith, J. P., *Taxing Popularity: The Story of Taxation in Australia* (Federalism Research Centre, Canberra, 1993), 18-24; and *Dictionary of American Biography*, 1st. ed., 'George, Henry,' (Johnson and Malone (eds.)), Vol. VII (Charles Scribner's Sons, New York, 1931), 211-212. A Henry George follower (also a Quaker) Lizzie Magie, created the precursor to the board game Monopoly in 1904 to demonstrate his theories (see: <http://www.answers.com/topic/henry-george>).

<sup>22</sup> In 1884, Hong Kong was one of the few colonies within the British Empire carrying zero debt. In fact Hong Kong ran a current account surplus for most of the years from 1873 to 1882 with that surplus in some years reaching close to 20% of total expenditure thus allowing the accumulation of very significant reserves. See, *The Colonial Office List for 1884*, (Harrison, London, 1862-1925), 18, 92. This savings habit has persisted; around mid-2013 Hong Kong's public foreign reserves exceeded US\$300 billion (see: <http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2013/20130328e2a1.pdf>.) of which approximately US\$85 billion are Government Fiscal Reserves (close to 2 years of total current Hong Kong government expenditure.) see: [http://www.gov.hk/en/about/abouthk/factsheets/docs/public\\_finance.pdf](http://www.gov.hk/en/about/abouthk/factsheets/docs/public_finance.pdf). The Hong Kong government has also historically been able to control expenditure quite effectively. Services were limited in keeping with 19th century practice but even more so given the remarkable self-reliance (repeated examples of dire poverty notwithstanding) of the majority Chinese population. This was the case from when the British established their Hong Kong colony and it remains the case to a very large extent, today (see, Goodstadt, Leo F., *Uneasy Partners: The Conflict Between Public Interest and Private Profit in Hong Kong* (Hong Kong University Press, Hong Kong, 2005).

<sup>23</sup> See note 3.

<sup>24</sup> Bartholomew, J., *The Welfare State Made Britain Poor*— extract from book at: <http://www.moneyweek.com/article/593/the-welfare-state-made-britain-poor.html>.

<sup>25</sup> *Pocket World in Figures 2005* (Profile Books / The Economist, London, 2004) 28.

<sup>26</sup> See: <http://databank.worldbank.org/ddp/home.do?Step=12&id=4&CNO=2>; and <http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx>. (GDP estimates are derived from Purchasing Power Parity (PPP) calculations.)

decades following 1945, from a war ravaged colony of less than 800 000<sup>27</sup> to a leading international service centre with a population of over 7.5 million.

Post-war governments in Hong Kong were, in fact, quietly but actively hostile to the idea of seeking low-cost development finance from the World Bank when Hong Kong was being re-built right through into the 1960s. Almost certainly, Hong Kong would have qualified to borrow from this then new international financial institution (which had been established in 1947). Successive Hong Kong governments implied they would accept such loans if they were offered on 'reasonable terms' – whilst, in reality, avoiding entering into any such borrowing for fear of the way the World Bank might begin to demand changes in the Hong Kong government's preferred economic model. In particular, the government worried that the World Bank would strongly advocate the adoption of a more modern tax system and insist on the collection of proper economic statistics.<sup>28</sup>

The opium-reliant revenue policies set down during the first 50 years of the colony proved to be remarkably strong. The indirectly strengthened land-based revenue system has proved to be so successful that it remains a mainstay of the Hong Kong fiscal regime to this day. On these foundations has been built an extraordinarily successful, low tax, trading economy which long ago gave up being opium-reliant.<sup>29</sup> These foundations were also fundamental in allowing the colony to thrive without need to resort to any sort of direct income taxation for around 100 years – and when such taxes came they were kept low and simple – see below. The very high levels of economic activity have been an important factor in maintaining sufficient revenues using a minimalist taxing approach. That minimalist taxing approach has, in turn, amplified the attractiveness of Hong Kong as a trading centre. A more business (or taxpayer) friendly tax regime operating within a normal (non-palm-tree) integrated trading economy would be difficult to find.

Those early experiences also demonstrated to Hong Kong that, even when financial public policies do not proceed according to plan, other alternatives which can help put things right may well emerge – *provided* your economy maintains strong growth. Above all, this growth - and Hong Kong's success - are attributable to the cross-generational, consistent energy, hard work, intelligence and remarkable self-reliance of the local population.<sup>30</sup>

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<sup>27</sup> See: <http://www.demographia.com/db-hkhist.htm>.

<sup>28</sup> Goodstadt, Leo F., *Profits Politics and Panics: Hong Kong's Banks and the Making of a Miracle Economy, 1935 – 1985* (Hong University Press, Hong Kong, 2007) 98-100.

<sup>29</sup> Against remarkable odds and as a product of an agreement between the UK and Qing Dynasty China, the officially sanctioned trade in opium between Hong Kong and Mainland China was increasingly and greatly reduced between 1907 and 1917. See, La Motte, Ellen N., *The Opium Monopoly* (MacMillan, New York, 1920) Chapter 15 (History of the Opium Trade in China) at: <http://www.druglibrary.org/schaffer/history/om/om15.htm>. The retailing and consumption of opium were finally made illegal in Hong Kong shortly after World War 2 (at US insistence) once the British resumed control of Hong Kong from the Japanese.

<sup>30</sup> Goodstadt puts it this way: 'There was never any need for the rulers to keep the people of Hong Kong at a distance or to exclude them from participation from government....It would have been hard to find anywhere a society more socially responsible and tolerant, more politically mature and self-reliant, or a people easier to serve and rule. They were ideal constituents, the secure foundations on which Hong Kong's success had been built despite the economic turbulence and political uncertainty...' see, Goodstadt, Leo F., *Uneasy Partners; The Conflict Between Public Interest and Private Profit in Hong*

### 3. PROFILE OF THE CURRENT REVENUE REGIME<sup>31</sup>

#### 3.1 A Turning Point

The first moves to introduce an income tax in Hong Kong came in December 1938 when Governor Northcote established the Taxation Committee to look at the possible adoption of income taxation in the jurisdiction. The committee recommended that an Income Tax be introduced.<sup>32</sup> The Chinese business community was ‘vehemently opposed in principal to any form of tax on income. In particular, they were opposed to any tax at all on business profits.’ Their stance quickly attracted the support of the expatriate business community.<sup>33</sup>

The committee proposed only a ‘partial income tax’ and while the colonial authorities ‘regarded the committee’s proposal as barely adequate, even as a temporary wartime measure,’ they nonetheless adopted the proposal.<sup>34</sup> The War Revenue Ordinance passed by the Hong Kong Legislative Council (LegCo) in 1940 created a system of schedules, establishing three separate taxes on different categories of income - a Property Tax with a flat rate, a Salaries Tax with progressive rates and a Profits Tax with a flat rate for corporations and progressive rates for unincorporated firms. The Ordinance exempted all offshore income from taxation.<sup>35</sup>

In drafting the Ordinance, the War Revenue Committee copied, it is said, the schedular British Income Tax system introduced by Prime Minister Addington in 1803, despite the fact that the British system itself had been reformed in 1910 to base tax liability on a taxpayer’s total income. In Littlewood’s view, the committee chose to copy a system which Britain, ‘had effectively discarded thirty years earlier’ because the representatives of business believed the separated schedular structure would reduce the possibility of future increases in tax rates.<sup>36</sup>

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*Kong* (Hong Kong University Press, Hong Kong, 2005), 228. There is claim, possibly apocryphal, that Friedrich Hayek once observed that ‘socialism is an excellent system – for up to 12 people’. The socio-economic operation of the typical Chinese family in Hong Kong lends a certain credence to this claim.

<sup>31</sup> The matters covered in this part are dealt with in more detail in Cullen and Wong, op. cit. note 3.

<sup>32</sup> Littlewood, Michael, ‘Taxation Without Representation: The History of Hong Kong’s Troublingly Successful Tax System’ (2002) *British Tax Review* 212. See, also: Littlewood, Michael, ‘Tax Reform in Hong Kong in the 1970s: Sincere Failure or Successful Charade?’ in Tiley, John (ed.), *Studies in the History of Tax Law* (Hart, Oxford, 2004); and Littlewood, Michael, *Taxation Without Representation: The History of Hong Kong’s Troublingly Successful Tax System* (Hong Kong University Press, Hong Kong, 2010).

<sup>33</sup> Littlewood, 2002, *ibid*.

<sup>34</sup> *Ibid*.

<sup>35</sup> *Ibid*. This approach was consistent with the 19th century tax policy – favouring sourced-based taxation in the colonies – adopted by the British as their Empire developed. See, Barker, William B., ‘Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa’ (2005) 109 *Pennsylvania State Law Review*, 101.

<sup>36</sup> Littlewood, 2002, *ibid*. The perception amongst the business elites that the reliance on separate schedules would help forestall future tax increases may not have been well founded, however. Significant discrepancies in tax rates applicable to personal exertion, corporate and income from property have characterized Australia’s uniform tax system for over 70 years now, for example. This level of discrepancy has produced strains and continues to attract criticism: ‘A large gap between the top personal income tax rate and the company tax rate creates an incentive to redefine personal income as company income’ (Shorten, Bill, *An Alternative Vision for Australia – Building our Nation*, at: [http://www.fabian.org.au/library/event\\_papers\\_2005/1118116108\\_23303.html](http://www.fabian.org.au/library/event_papers_2005/1118116108_23303.html)). Despite this long history of significant tax rate divergence, the Australian tax system has remained politically workable

The War Revenue Ordinance (1941) replaced its predecessor and introduced small changes, including the introduction of an additional Interest Tax and an increase in the maximum rate of taxation.<sup>37</sup> The new Ordinance, however, was short-lived. In December 1941, six months after its adoption, Hong Kong was occupied by the Japanese.

The new, post-war, 1947 tax legislation passed by LegCo, the Inland Revenue Ordinance (IRO), retained the basic schedular structure and the restricted territorial ambit of the War Revenue Ordinance of 1941. There were separate schedules for salaries, profits and interest originating in Hong Kong (with low tax rates). Since 1947, the IRO has been formally re-examined on three occasions, in 1954, 1968, and 1976, by Review Committees. No major alterations have been made to the IRO, however.

The 1976 review committee made the most significant recommendation for reform when it suggested that Income Tax should be assessed on total income, eliminating the separated schedular system of assessment. In 1978, the Government was still considering this recommendation but, by the following year, the authorities had decided not to pursue such a reform. The Government's decision was again, it would seem, influenced by the business community's 'firm and vociferous opposition to tax reform.'<sup>38</sup>

### 3.2 The Current System

As noted above, the British established Hong Kong as a Free Port which meant that goods could enter and leave free of any customs or similar duties. This continues to be the case today. Indeed, Hong Kong has long prided itself on its low rate and simple RR.<sup>39</sup> Direct taxes applied to business profits and earned income still remain amongst the lowest in the developed world.<sup>40</sup>

The RR in the HKSAR today encompasses the following key features:<sup>41</sup>

- A narrow taxation base;
- Low taxation rates;
- Separate schedules applying separately identified taxes to different classes of income – no general income tax;
- No taxation of income derived from outside of Hong Kong regardless of the residence status of the taxpayer (source-based taxation);
- Simple and relatively stable taxation laws;
- Retention of Stamp Duties in the system;

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over many decades, however. See also, Sorensen, Peter, Birch, The Nordic Dual Income Tax – In or Out? at: <http://www.econ.ku.dk/pbs/diversefiler/oecdual.pdf>.

<sup>37</sup> Littlewood, 2002, *ibid*.

<sup>38</sup> Littlewood-2004, *op. cit.* note 32.

<sup>39</sup> Reynolds, Alan, Hong Kong's Excellent Taxes, at: [http://www.cato.org/pub\\_display.php?pub\\_id=3793](http://www.cato.org/pub_display.php?pub_id=3793).

<sup>40</sup> See table at: <http://www.forbes.com/global/2005/0523/024chart.html>. See also, table at: <http://invest.vic.gov.au/About+Melbourne/Doing+Business+in+Melbourne/Taxation.htm>.

<sup>41</sup> This outline of the current Hong Kong revenue system summarises and updates a more comprehensive review of the taxes applying in the HKSAR, which can be found in Cullen, Richard, 'Revenue Law in Hong Kong: The Future' in (Wacks (ed.)) *The New Legal Order in Hong Kong* (Hong Kong University Press, Hong Kong, 1999) Chapter 12.

- Until recently almost no use of Double Taxation Treaties (DTTs);<sup>42</sup>
- Comparatively constrained government spending;
- Very little government borrowing;
- Infrequent deficit budgeting; and
- Massive accumulated Fiscal Reserves.

The main taxes imposed (using separate schedules) by the IRO are:

- Profits Tax;
- Salaries Tax; and
- Property Tax.

Profits Tax, the most important tax in terms of revenue raised, is imposed by Part IV of the IRO. The crucial practical and legal issue is source: only profits which can be shown to have (or which, in a few limited cases, are deemed to have) a source in Hong Kong are subject to profits tax. The adherence to this source rule has been driven, to a large extent, by the desire of businesses, at all levels, to use Hong Kong as a base from which to operate without incurring tax on any offshore operations.<sup>43</sup> The operation of the source principle in Hong Kong has been the subject of much litigation. Overall, its application has, historically, worked fairly well, however.<sup>44</sup> Hong Kong remains, in practice, the last remaining first-world jurisdiction to rely so heavily on a rule which excludes from the tax-net all profits which can be shown to have arisen outside of the jurisdiction.<sup>45</sup>

Salaries Tax, which is imposed by Part III of the IRO, is also an important funding source. Salaries Tax applies at progressive rates but it is subject to fixed percentage 'maximum' or 'standard' rate on total taxable income.<sup>46</sup> The Salaries Tax system is also source-based but the specified source rules in Part III (backed by case law and

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<sup>42</sup> Hong Kong's approach to DTTs has been changing since 1997, however. As a result of external pressures and international campaigns against Tax Havens, the HKSAR has now signed up to over 20 DTTs. See further, Liu, Irene Jay, 'HK Seeking Tax Treaties to Silence Tax Haven Claims', South China Morning Post, March 31, 2012.

<sup>43</sup> The motivation for retaining a source-based taxation system dates back to Hong Kong's original status as a Free Port. This status meant that Hong Kong was a place where trading business could be done, in the 19th century, without need to be concerned about taxation, either through Customs Duties or Income Tax. As the need for some sort of Income Tax was grudgingly conceded just prior to and after World War 2 (see discussion above) the impact of the new Tax Regime was restricted from the outset by the incorporation of a source rule restricting the application of Profits Tax to profits arising within Hong Kong. This sourced-based taxation regime has remained highly attractive to business as Hong Kong has, since the 19th century, made the transition from trading port, to manufacturing centre to, nowadays, a sophisticated, mostly service-based economy. See, further, Cullen and Wong, *op. cit.* note 3.

<sup>44</sup> Halkyard, Andrew, 'The Hong Kong Tax Paradox' (1998) 8 *Revenue Law Journal* 1, 20. This article contains a useful summary of the key cases on source.

<sup>45</sup> Cullen and Wong, *op. cit.* note 3. See, also, Major Sources of [HKSAR] Government Revenue (June 2011) at [http://www.legco.gov.hk/yr10-11/english/sec/library/1011fs05\\_20110621-e.pdf](http://www.legco.gov.hk/yr10-11/english/sec/library/1011fs05_20110621-e.pdf) (Profits Tax generated 29.6% of Government Revenue in 2009-2010).

<sup>46</sup> The term 'flat tax' is often used as a (rather inaccurate) short-hand term in place of the more correct 'maximum' or 'standard' tax rate. See also, Major Sources of [HKSAR] Government Revenue (June 2011) at [http://www.legco.gov.hk/yr10-11/english/sec/library/1011fs05\\_20110621-e.pdf](http://www.legco.gov.hk/yr10-11/english/sec/library/1011fs05_20110621-e.pdf) (Salaries Tax generated 16.3% of Government Revenue in 2009-2010).

Departmental Interpretation and Practice Notes) have meant that source is less of an issue than with Profits Tax.<sup>47</sup>

The final schedular tax imposed by the IRO is Property Tax, which applies at a flat rate on rent received, less a statutory allowance of 20% for repairs and maintenance. Corporations owning property are exempt from property tax – they pay Profits Tax on rents received instead.

Betting Duty (on horserace, lottery and football betting) imposed by the Betting Duty Ordinance (1950), normally raise less than 10% of total revenue. Estate and Gift Duties used to be imposed by the Estate Duties Ordinance (1950) but these duties ceased to operate in 2006.<sup>48</sup> The yield from these duties had been quite low for some time.<sup>49</sup> Other comparatively minor sources of revenue include: property rates, various fees and duties (such as Excise Duties on tobacco, alcohol and petroleum products) utility charges and vehicle-related imposts. More significant, non-taxation sources of revenue include: investment and interest income (on Fiscal Reserves and direct land-transaction revenues (already noted in Part 2 and discussed, further, below).

Despite this low tax regime, Hong Kong has still managed to provide public housing on a massive scale, to finance excellent transport and communications systems and comparatively sound education and health systems.<sup>50</sup> At the same time, it has managed to amass public foreign currency reserves of over \$US300 billion.<sup>51</sup>

<sup>47</sup> Cullen and Wong, *op. cit.* note 3. See too, DIPN 10 The Charge to Salaries Tax at: [http://www.ird.gov.hk/eng/pdf/e\\_dipn10.pdf](http://www.ird.gov.hk/eng/pdf/e_dipn10.pdf).

<sup>48</sup> See, Revenue (Abolition of Estate Duty) Ordinance 2005, at: <http://www.ird.gov.hk/eng/tax/edu.htm> See, also, Hong Kong – Abolition of Estate Duty, at: <http://www.bakernet.com/NR/rdonlyres/3834909F-DAF6-403E-B6E9-ED3DC84F088A/38385/HKAbolitionofEstateDuty.pdf>. The argument is that, by becoming one of the first jurisdictions in East Asia to remove Death/Estate/Gift Duties, Hong Kong will: help small Hong Kong businesses with cash flow problems; encourage increased location of assets in Hong Kong; and strengthen the HKSAR's position as a location for regional fund managers (see, Abolition of estate duty helps promote HK's asset management business, at: <http://www.fstb.gov.hk/eng/sfst/fstb19.html>.)

<sup>49</sup> The Hong Kong Institute of Certified Public Accountants estimated that the EDO typically generated less than 1% of total government revenues (see, Estate Duty Review Consultation Document, at: [http://www.hkicpa.org.hk/professionaltechnical/taxation/submissions/submission\\_201004.pdf](http://www.hkicpa.org.hk/professionaltechnical/taxation/submissions/submission_201004.pdf).)

<sup>50</sup> Cullen and Wong, *op. cit.* note 3.

<sup>51</sup> See note 22. These Fiscal Reserves are known, officially, as the Exchange Fund. The Exchange Fund, today, essentially comprises: (A) the Fiscal Reserves (money saved from revenues raised but not spent over previous decades) of the Government's General Revenue Account (roughly 40% of the Exchange Fund); and (B) the balance of government foreign currency reserves which back the Hong Kong Dollar (HKD) (roughly 60% of the Exchange Fund). (Until 1998, a separate Land Fund was also retained by the Hong Kong Government. In that year, the assets of the Land Fund were merged with the Exchange Fund – although the uses to which the Land Fund could be put remained restricted (primarily to capital expenditure). See, Merger of Land Fund Assets into Exchange Fund, at: <http://www.info.gov.hk/hkma/eng/press/1998/981117e.htm>.) The Exchange Fund is managed by the Hong Kong Monetary Authority (HKMA). The HKMA also manage the quasi-currency board pegging of the HKD to the US Dollar (USD). That part of the Exchange Fund backing the HKD covers about 240% of all HKD notes and coins in circulation plus certain other securities. It only covers about 30% of all HKD deposits, however. A Currency Board fixes the exchange rate of Currency A (the HKD in this case) to an 'anchor', much stronger Currency B (the USD in this case) at a fixed rate and promises to convert cash and equivalent holdings of Currency A to Currency B at any time at the fixed rate (see, <http://users.erols.com/kurrency/intro.htm>). It is argued that Hong Kong does not have a real Currency Board system because, amongst other things: (a) the HKMA manages the HKD other than in accord with strict Currency Board principles; and (b) the HKMA (unlike a true Currency Board) also operates like a



### 3.3 The Fiscal Firewall

The crucial role of the Basic Law (see note 3) is to provide for a high degree of separation of the HKSAR from the Mainland (Two Systems) within the PRC (One Country). Particular effort has been put into drafting provisions in the Basic Law which are designed to install a constitutional, ‘fiscal firewall’ between the two Tax Systems.

Article 106 of the Basic Law provides that Hong Kong is to have its own independent finances and prohibits the PRC from raising taxes in Hong Kong or sharing the HKSAR’s tax revenue. Article 108 further provides that:

The Hong Kong Special Administrative Region shall practise an independent taxation system.

The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.

The Preamble of the Basic Law also stresses the need to preserve the prosperity and stability of Hong Kong.

Some 16 years after the handover, the policy of separating the two Tax Systems has been followed practically to the letter. Both economies (and the participants in those economies) operate within the context of two entirely separate Tax Systems. This is recognized, too, in the Double Tax Arrangement in place which applies to the two Tax Systems. This separation is well recognized outside of the PRC and the HKSAR, for example, by the Australian Taxation Office.<sup>52</sup>

## 4. TAX POLICY LESSONS GOOD AND BAD

### 4.1 Introduction

I believe there are two primary (interlocked) positive lessons to be drawn from the Hong Kong Revenue Policy experience. The paramount, evolved-innovative, policy idea is the continuing use of land, to this day, as a fundamental public revenue source.

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Central Bank, in certain respects – by regulating the banking and financial systems. See, further: *An Introduction to the Hong Kong Monetary Authority*, at: [http://www.info.gov.hk/hkma/ar2004/english/summary/summary\\_eng.htm](http://www.info.gov.hk/hkma/ar2004/english/summary/summary_eng.htm); Lo, Chi, *The Demise of the Hong Kong Dollar*, at: <http://www.chinabusinessreview.com/public/0303/commentary.html>; and Greenwood, John, *Hong Kong’s Link to the US Dollar* (Hong Kong University Press, Hong Kong, 2008). The unprecedented heavy reliance by the HKSAR Government over several consecutive years following the Asian Financial Crisis, which commenced in mid-1997, was paid for out of the Government’s Fiscal Reserves in the Exchange Fund. No borrowing was needed to fund deficits which exceeded 20% of Government expenditure in some years. This deficit financing ran for 5-6 years. Within a further 5 years, the Fiscal Reserves were fully replenished and stronger than ever (see, too, note 22). Unlike in the case of accessing additional revenues through extra taxation, where the approval of LegCo is mandatory, the HKSAR Government can access the Fiscal Reserves without being compelled to seek approval from the Legislative Council (LegCo).

<sup>52</sup> See, Australian Tax Office, Taxation Ruling TR97/19, Income Tax: Tax Implications of Resumption of Chinese Sovereignty over Hong Kong.

By conventional modern measures, Hong Kong is frequently said to have a narrow tax base.<sup>53</sup> We can see from the outline in Section 3.2 why this claim is made and why it is cogent. If, however, we consider the full *revenue base* of the HKSAR, the picture changes markedly. When land-related revenues are factored in to the public revenue calculation, it turns out that Hong Kong has, in one important way, a far more broad revenue base than probably any other (non-oil-based) developed jurisdiction. Thus, in the Forward Estimates for 2013-2014, land revenue is estimated to be 16% of total Government revenues<sup>54</sup> Such revenues have exceeded 20% of total revenues in the relatively recent past.<sup>55</sup> This is essentially just the sum for land sales and lease modification premiums. It does not include Stamp Duties and the IRO taxes arising from income directly related to the real estate sector.

A positive concomitant of the (conventionally) narrow tax base is the clear, relative low rate, operational simplicity of the Hong Kong RR. This is the second key positive lesson which Hong Kong offers: it is possible to maintain, in the modern era, a low rate, highly effective revenue regime which is minimalist, clear and easy to comply with – where you have been able to retain a significant, land-based, revenue source. The ‘system simplifying role’ of these land-related public revenues commenced in 1842. They continue to underpin Hong Kong’s low rate, simple, low compliance cost RR over 170 years later.

The success of this evolved-innovation also underpins the primary, bad aspects of the HKSAR RR, however. Again, two stand out. Broadly stated, these are notable revenue policy inflexibility and the high on-cost effects of the land-based, revenue system.

## 4.2 Land-Related Revenues

We need, at this point, to revisit the land-based revenue system to understand its scope and operation in greater depth. As we saw above, from its inception, British Hong Kong did not allow (virtually) any sale of freehold land. All land was made available as leasehold land. Moreover, the practice grew of restricting the availability of land for development. This tended to drive up the price of land (towards the upper limits of what the market would accept) and revenue receipts.

The entire land management system has become self-reinforcing and, arguably, financially addictive (for the Government).<sup>56</sup> Government land policy has fostered one of the highest population densities of any major city in the world. Hong Kong has more skyscrapers, at over 7 400, than any other city on the planet, including New York.<sup>57</sup> The majority of these are residential. This density has allowed the provision of first rate transport and communications systems with greater speed and lower cost than would otherwise have been the case. It has also, originally incidentally and now as a matter of

<sup>53</sup> See, for example, IMF, Hong Kong SAR: Preliminary Conclusions of the 2004 Article IV Consultation Mission, at: <http://www.imf.org/external/np/ms/2004/110204.htm>.

<sup>54</sup> For 2013-2014, total Government revenue is estimated to be US\$56 billion with land revenue making up almost US\$9 billion of that sum.

<sup>55</sup> See, Loh, op. cit. note 21.

<sup>56</sup> Brown, Stephen, Fung, Edward K. W., Loh, Christine, Uebergang, Kylie and Xu, Stephen, The Budget and Public Finance in Hong Kong,, 34-35, at: <http://www.civic-exchange.org/publications/2003/BudgetReport.pdf>.

<sup>57</sup> ‘Tall Buildings’, The Economist, April 9, 2005, 90.

policy, left the greater part of Hong Kong's total area either subject to low density use or zoned as public (mostly park) areas.<sup>58</sup>

Government policy has, predictably, had a significant upward impact on the price of land. The Government, historically, could always, it seemed, rely on accessing additional revenue by leasing land long-term (as the sole supplier) into a market with ever rising prices. The Government also takes a large fiscal bite from many secondary market transactions. Strict usage conditions are stipulated in each government lease. If a developer purchases an old building wishing to rebuild at say five times the height of the building to be replaced, the developer needs to obtain a variation to the purchased lease. To get this, the developer has to pay a substantial 'lease modification premium' to the Government.

A good way to get a feel for just how financially significant this system is, in operation, is to look at an example. In 1995, the Hong Kong Government put a parcel of land (Lot 129) of around 180 000 square feet up for sale on Ap Lei Chau, which is an island located to the south of Hong Kong island. Ap Lei Chau is connected by a causeway bridge to neighbouring Aberdeen on Hong Kong island. The whole area is densely populated. As is the case across much of Hong Kong, this high density urban areas is surrounded by wooded mountains and hills and the sea.

Lot 129 is located along the Ap Lei Chau waterfront, across a road from numerous smaller scale shipyards which service the local fishing fleet and the many pleasure junks and luxury yachts moored in the large Aberdeen Typhoon Shelter. The Government sold the Lot 129 lease – for industrial use – for just under US\$30 million in 1995 to a secondary commercial-industrial developer. By 2005, two primary residential property developers had acquired a significant interest in Lot 129 (by now valued at about US\$74 million). The two property developers needed to have the lease modified to allow a major, high-end residential development in several modern high-rise tower blocks. The lease modification premium – paid to the Government - to convert the lease from the original-sale industrial use to the high-end residential use was approximately US\$504 million. The Hong Kong Government thus derived around US\$534 million within around 10 years, from the two Lot 129 transactions.<sup>59</sup>

There are, of course, market limitations on just how high land prices may be pushed by a government – even within a comparatively closed system such as that which has operated in Hong Kong. That is, the Government cannot simply set any price for land it chooses. If a price is too high, then buyers in the market simply will not respond. Thus the Hong Kong Government has had experience with trying to sell commercial land where there were simply no takers.<sup>60</sup> More recently, following the onset of the

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<sup>58</sup> This does not mean that the Government has especially good 'green' credentials. On the contrary, successive Hong Kong Governments have displayed almost a mania for land reclamation from Victoria Harbour and beyond and for massive road and bridge building projects, for example. See, further, Loh, Christine, *Alternative Policy Address 2005-2006*, at, <http://www.civic-exchange.org/publications/2004/apa05e.pdf>. The fact that Hong Kong has taken a very high density approach to building (thus maximising government land-related revenues) has, by accident more than design, left much of its land area comparatively under-developed or undeveloped.

<sup>59</sup> For a detailed, well documented record of this transaction, see Webb, David, Larvotto – Do You Know the Boatyard? March 3, 2010, at: <http://webb-site.com/articles/larvotto.asp>.

<sup>60</sup> The Hong Kong Government experienced serious difficulties in selling (leasing) land for commercial / industrial use in East Kowloon in the past, for example (discussion with Leo Goodstadt, September 30, 2005).

Asian Financial Crisis in mid-1997 the Government found it difficult to sell plots for residential development. Moreover, between mid-1997 and 2003, residential property values dropped by around 70%. Today those values are back at, or higher than the 1997 levels. Subject to these fundamental constraints, successive Hong Kong Governments have played a significant role in creating conditions which have typically put upward pressure on land values.<sup>61</sup>

In theory, one might aim to replicate this Hong Kong model of accessing land-related revenues by: (a) introducing a very high rate, annual land tax system, combined with; (b) greatly increased charges for zoning changes and planning/building permits. In some jurisdictions with Bills of Rights, for example the USA, constitutional protection of (real and other) property rights presents immediate and complex challenges for any such plan.<sup>62</sup> Even where such constraints do not apply, such a scheme would be far less effective in terms of scope - or political feasibility- than a scheme such as that applying in the HKSAR which pivots around the *core proprietary interest* retained by the Government in virtually all land. A measure of the accuracy of this view is the lack of evidence any operational example of such an alternative model capable of producing revenues at the levels enjoyed in Hong Kong, now, for around 170 years.<sup>63</sup>

### 4.3 Simple, Low Rate Tax System

The 'system simplifying role' of land-related public revenues commenced in 1842. These rather special revenue foundations depended for their success, prior to World War 1, on the then substantial legal international trade in opium and the way in which that trade consolidated the role of British Hong Kong as a major trading port and entrepot to Imperial China.

Apart from the opium-related revenues (which took decades to become significant) these land-related revenues were fundamental in allowing the colony to thrive without need to resort to any sort of direct income taxation for around 100 years. When such taxes came they were kept low and simple.

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<sup>61</sup> 'Bubble-economy' real property values became established during the final years of British rule. Property prices began to collapse by 1998, shortly after the Asian Financial Crisis (AFC) hit. By 2003, at the height of the Severe Acute Respiratory Syndrome (SARS) health crisis, residential property prices had fallen by about 70% from their bubble-market peak. This, in turn, had a devastating impact on the revenue flow to the HKSAR Government. The Government came to rely, over a period of years (and for the first time in living memory) on substantial deficit financing to meet recurrent expenditure (see note 51). The dramatic collapse in prices was amplified greatly by the HK Dollar currency peg to the US Dollar (see note 51). After the AFC hit, the US Dollar rose greatly in value, taking the HK Dollar with it. With no currency adjustment possible in the HKSAR to cushion the impact of the AFC, asset values sank savagely and fairly swiftly. As it happens, default rates on mortgages remained very modest - especially considering the very high level of negative equity mortgages (around 100,00 in June, 2003 - or 29% of all residential mortgage loans - see: Residential Mortgage Loans in Negative Equity, at: <http://www.hkeconomy.gov.hk/en/pdf/box-03q3-3-1.pdf>.) Mass market residential property values have since recovered from the low point in 2003 and they now are back to or exceed 1997 levels.

<sup>62</sup> See, for example: Rose, Carol M., 'Property as the Keystone Right' (1996) 71 Notre Dame Law Review, 329; and 'Property Rights and the Constitution' in Cato Handbook For Policy Makers (7th Edition) at: <http://www.cato.org/sites/cato.org/files/serials/files/cato-handbook-policy-makers/2009/9/hb111-34.pdf>.

<sup>63</sup> I am grateful for the discussion generated during the Tax Workshop for drawing my attention to this possible alternative approach.

As we saw in Section 3.2, they remain so using any modern comparative measure. Income tax in the HKSAR applies at low rates and is firmly territorial or source based.<sup>64</sup> Income taxes are applied by the IRO using separated schedules and there is typically no tax on dividends or interest and no Capital Gains Tax.<sup>65</sup> Goods and services are left largely free of formal taxation.<sup>66</sup> Fringe benefits are barely taxed.<sup>67</sup>

The IRO has remained not that much longer today (set out in two official languages) than it was when enacted in 1947. Apart from being short, it is fairly straight-forward to read. Compliance costs are comparatively minimal. In fact for around 60% of wage and salary earners, they are essentially zero. Due to the rather generous fixed allowances applying to Salaries Tax, the majority of potential taxpayers in this category fall below the taxable threshold.

Even collection is kept simple – at least for the Inland Revenue Department – as the HKSAR still uses a Provisional Tax system rather than a Pay-As-You-Go system.

And still this system has played a key part of building up those massive Government Fiscal Reserves – enough to cover almost two years total recurrent public spending.<sup>68</sup>

Hong Kong has been able to adhere to the advice of William of Occam (to keep it as simple as possible) even it has done so instinctively. For this reason, amongst others<sup>69</sup>,

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<sup>64</sup> Holmes, Kevin, *The Concept of Income – A Multi-Disciplinary Analysis* (IBFD, Amsterdam, 2001) 28–29. Holmes noted, as examples of schedule-based systems, Hong Kong, Belarus, Sudan and the UK. In the case of the UK – and unlike Hong Kong – although the schedules remain in the form, as a matter of practice, a single income tax is applied to collective income, see: *Tax in England*, at: [http://www.adviceguide.org.uk/index/life/tax/income\\_tax/index/life/tax/income\\_tax.htm](http://www.adviceguide.org.uk/index/life/tax/income_tax/index/life/tax/income_tax.htm); and *Income Tax*, at: <http://www.economicexpert.com/a/Income:tax.html>.

<sup>65</sup> Section 14 of the IRO, which imposes Profits Tax, specifically excludes capital profits from assessment of Profits Tax. Section 14 does tax ‘trade’, however, and the case law – and the IRO definitions section – stipulate that this term includes ‘an adventure in the nature of trade’. Thus, one-off transactions can still be regarded as ‘trading’ in certain circumstances (normally fairly rapid re-selling of real estate) and taxed accordingly.

<sup>66</sup> It is arguable that the Hong Kong Government’s long established, high land price policy has imposed a ‘de facto’ Consumption Tax on all consumers in Hong Kong. Inflated land prices (which have benefited the Government most of all) have driven up the costs of doing almost every sort of business in Hong Kong because of high rents or high initial land-purchase costs. These input costs have then been passed on to all consumers as prices for goods and services have been set.

<sup>67</sup> Reduced taxes apply to the provision of employee housing and certain education and share benefits. Otherwise, the ‘cash-convertibility’ rule applies. This rule, which is based on old English case law, provides that provided an employee fringe benefit is not paid in cash and cannot be converted to cash by the employee, then it will not be considered a perquisite which can be taxed as part of a salary or wages.

<sup>68</sup> See, note 22.

<sup>69</sup> Other economic-success, influencing factors include the relatively small ‘City-State’ nature of the economy and the extraordinary range of (changing) trading opportunities related to China from 1842 onwards. The British also brought with them a style of experienced, pragmatic colonialism which included an understanding of how to build sound governance based on sound institutions (including the Rule of Law) (see, Tso, Kevin, ‘Fundamental Political and Constitutional Norms: Hong Kong and Macau Compared’ (2012) 13 Australian journal of Asian Law, available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2159544](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2159544)). Above all, Hong Kong’s economy flourished because of the remarkable collective hard work and astuteness of the local Chinese population (see note 30).

it has escaped falling prey to the ‘million monkeys’ syndrome.<sup>70</sup> No mean achievement for Tax System operating within a developed, First World economy.

#### 4.4 The Bad Examples

As noted previously, the success of this evolved-innovation also underpins the primary, bad aspects of the HKSAR RR. The two foremost bad lessons are: revenue policy inflexibility and the high on-cost effects of the land-based, revenue system, which are intertwined.

##### 4.4.1 The Revenue Policy Deficit

Given the advanced nature of the economy in the HKSAR, the lack of institutionalized revenue/tax policy planning is notable. The HKSAR Government itself lacks any sort of high level, standing Tax Policy research infrastructure as does the Inland Revenue Department. When official Revenue Policy research is undertaken, a committee is typically formed, where professional, academic and public input is sought.<sup>71</sup> The most recent example was in 2000, when the HKSAR Government set up an Advisory Committee on New Broad-Based Taxes.<sup>72</sup> This was done at the height of the deficit-financing era following the onset of the AFC.<sup>73</sup>

Within the tax academic and professional community in the HKSAR, there is a view that this long-time, largely ad hoc approach to Tax Policy research and review puts those seriously urging reform, including the HKSAR Government, in a weakened position.

It is almost always the case with tax reform, that one can rely a wide array of ‘Status Quo Warriors’ (SQWs) to man the roadblocks. This is particularly the case in Hong Kong. Take the debate over the possibility of introducing a Goods and Services Tax (GST) in Hong Kong which unfolded from 2004 to 2006: the SQWs included the widest cross-section of civil society from plutocrats through to ‘grass roots’ groups. They were ranged against an intimidated Government<sup>74</sup>, moderately backed up by some professional and academic commentators – and the IMF.

<sup>70</sup> Gerber, Paul (Senior Member Administrative Appeals Tribunal (Australia)), ‘I suspect that if a million monkeys were put in front of a million typewriters, by Wednesday one of them would have come up with an improved version of the [Australian] Income Tax Act.’ Quoted in: Burns, Lee and Krever, Richard, ‘Individual Income Tax’ (in Thuronyi (ed.)) Tax Law Design and Drafting (Volume 2) (International Monetary Fund, Washington, 1998) Chapter 14.

<sup>71</sup> For a thorough review of historical attempts to introduce reform, see Littlewood, (2002) and Littlewood, (2004), op. cit. note 32. See, too, Halkyard, Andrew, The Hong Kong Tax Paradox, or Why Jurassic Park Exists in the Pearl River Delta (1998) 8 Revenue Law Journal, 1; and Tang, Shu-Hung, The Political Economy of Tax Reform in Hong Kong (2005) Asia-Pacific Journal of Taxation, 52. Tang provides a useful review of the history of previous discussions (and failed attempts) to introduce a general tax on consumption in Hong Kong.

<sup>72</sup> See: See, A Broader Tax System for Hong Kong, at: <http://www.fstb.gov.hk/tb/acnbt/english/finalrpt/finalrpt.html>.

<sup>73</sup> See, note 51.

<sup>74</sup> The fact that no one within the Government, not even the Chief Executive (Head of Government) is democratically elected helps explain a significant part of this timidity. The HKSAR has a plurality of newspapers and magazines expressing the widest range of views – far more so than in Australia or Canada. Social media is even more animated and the broadcast media can also very ‘lively’. In fact, no other place in the developed world combines so much civic freedom with so much political restriction. One result is that HKSAR Governments have tended towards caution far more than one would expect

At the same time as it released the relevant discussion document (based on the Advisory Committee's work) the Government instigated a public consultation period (from July 2006 to March 2007) on the possible directions for reform. After the announcement of the public consultation period, Hong Kong quickly witnessed a series of significant demonstrations against the GST proposal (which was clearly favoured in the official discussion document). Given the intensity of opposition to the GST in the streets (echoed in much of the media) and the fact that political parties from across the political spectrum (pro-government/Beijing and pan-democrat) expressed hostility to the tax, the Government withdrew it as an option 'on the table' in December 2005, well before the consultation period was over.<sup>75</sup>

One elementary component of the explanation for this lack of forward revenue policy planning is the very success of the current system and, in particular, its long proved capacity to build up huge Government Fiscal Reserves. As noted earlier, these now stand at around US\$85 billion. They are readily available for Government use – formal LegCo approval is not required for an appropriation from the Fiscal Reserves.<sup>76</sup> Thus it is easy to argue 'Why should we plan – the system has worked so well and we enjoy a super-solvency. Long-term Tax Policy planning is driven by the need to maintain high-complexity social welfare systems and to service very significant debt – neither of which reality burdens Hong Kong.'

Allied to this point of view is the 'Scrooge Mc Duck' factor. Walt Disney's Uncle Scrooge famously fashioned a single future planning strategy: build a huge Money Bin and keep it filled to the brim. Do these two things, and you will be ready for any challenge which the future may present. Alex Lo, a thoughtful (and acerbic) writer at the South China Morning Post recently put it this way:

[O]ur city is full of people from desperate families who don't even have a home where they can be properly cared for. Hong Kong is sitting on HK\$1.38 to HK\$1.6 trillion in reserves, depending on how you calculate it, equivalent to 70 per cent of the city's gross domestic product. In 2012/13, our fiscal surplus is HK \$64.9 billion - against an original forecast of a HK\$3.4 billion deficit. But thanks to officials like our Ebenezer Scrooge of a financial secretary John Tsang Chun-wah, we won't be using a cent of that if the money doesn't come from our annual fiscal budget.<sup>77</sup>

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given the level of power conferred on them by the Basic Law and the lack of any need to face the general electorate. This arrangement is, in fact, part of the British legacy. Beijing prefers this arrangement but it did not create it. See, also, discussion at Section 4.5, below.

<sup>75</sup> Cheng, Jonathan, Sales tax fiasco clouds Tang's fourth budget, *The Standard*, February 26, 2007 at: [http://www.thestandard.hk/news\\_detail.asp?we\\_cat=4&art\\_id=38915&sid=12372543&con\\_type=3&d\\_str=20070226](http://www.thestandard.hk/news_detail.asp?we_cat=4&art_id=38915&sid=12372543&con_type=3&d_str=20070226). Hong Kong's political parties remain divided primarily according to whether they support faster-paced or slower/very slow-paced further democratization, with pro-Beijing and pro-government parties all being in the latter camp. The Pan-Democratic camp are, however, now also split into a wide range of different groups and parties where tense relations and regular squabbling are common. See Lo, Alex: 'Alliance a Recipe for Democratic Impasse', *South China Morning Post*, March 25, 2013, 2. See, also, Lo, Alex: 'Pan-Dem Elders Offer a Slither of Hope', *South China Morning Post*, January 8, 2013, 2; and 'Hysteria will not hasten Democracy' *South China Morning Post*, March 13, 2013, 2.

<sup>76</sup> See note 51.

<sup>77</sup> Lo, Alex, 'Just Whose Rainy Day is it, Mr Tsang?', *South China Morning Post*, April 25, 2013, 2. See, too, Latter, Tony, 'Shaping a Budget Strategy for Hong Kong' in, *Hong Kong's Budget: Challenges and Solutions for the Long Term* (Civic Exchange, Hong Kong, 2009) at: <http://civic->

Instinctively if not always explicitly, the majority within Hong Kong's business and professional elite groups likely feel that this almost studied avoidance of detailed Revenue Policy planning is a 'good thing': with such planning comes greater understanding – and with that, enhanced (and informed) demands for provision of particular (usually publicly-financed) services.<sup>78</sup>

#### 4.4.2 The On-Cost Impact

The broad outlines of the way in which the land-related revenue system has evolved and now operates have already been set out. We need, now, to consider some more of the relevant detail, though, due to limitations of space, in a rather simplified form.<sup>79</sup>

It has become attractive for both the Government and major developers for (new leasehold) land for sale to be released in large very expensive lots. For developers, it means only the major members of their group (there are around 20 large-scale developers) can readily come to the market in many cases. For the Government these, usually very highly cashed-up, developers are able to pay the huge up-front lease premiums swiftly. Government rental payments on the purchased leases are minimal compared to the premiums. In a way, the Government has a limited 'cache' of highly solvent 'taxpayers' who pay vast 'land taxes' almost completely in advance.

For a range of reasons, it would make good sense to move away from the current format to one where Land Premiums were significantly reduced and, in tandem, Government Rents on those leases were lifted. This would lower the initial cost of land (and Government income) whilst providing a much fattened long-term flow of enhanced primary rental payments.<sup>80</sup>

For different range of reasons this is a most difficult political-economic task. One can rely almost certainly, once more, on many of the usual the SQWs to take a stand against any such move. Moreover, both Government and big developers are accustomed to and comfortable with the current system in many embedded ways.

The consequences of the current regime, in the way in which it has developed in modern Hong Kong, however, can be highly disruptive for doing business. Sub-leases for all forms of businesses, large and small, are made more expensive by the high up-front costs associated with the underlying lease. This encourages short-term leasing (to lower immediate risk), which, especially in a market of rising rents, is a key source of instability, particularly for smaller businesses.<sup>81</sup>

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exchange.org/en/live/upload/files/200902\_budget.pdf, where the author suggests that some may derive a certain 'fiscal virility' satisfaction from this striking savings success.

<sup>78</sup> Goodstadt has noted the way in which British administration in Hong Kong maintained an active hostility to collecting economic statistics after the last War for just such reasons, see note 28 and accompanying text. Once more one can see how the roots of these Tax Policy lessons, good and bad, are essentially British.

<sup>79</sup> For a first class review of the historical development of Hong Kong's direct land-related revenue system, complete with systematic reform proposals, see: Webb, David, Hong Kong Land Lease Reform Part 1 (October 7, 2010) at: <http://webb-site.com/articles/leases1.asp>; and Hong Kong Land Lease Reform Part 2 (November 1, 2010) at: <http://webb-site.com/articles/leases2.asp>.

<sup>80</sup> Webb (Part 2), Ibid.

<sup>81</sup> Ibid.



This means all goods and services provided in Hong Kong have a higher than usual rent-recovery component. Hong Kong has thus had, it is fair to say, a *de facto* general consumption tax particularly since World War 2, when ground rents began to fall in significance and the up-front land premiums grew and grew as the economy (generally) boomed.<sup>82</sup>

The current system also typically ensures higher than usual pricing for residential properties (which also normally are quite small<sup>83</sup>). For those ‘in the system’ this has an upside, of course. For those trying to buy-in for the first time, it can be particularly difficult.<sup>84</sup>

The single factor which has made the serious on-cost drawbacks of the land revenue system sustainable over the post-War decades has been Hong Kong’s vast stock of Public Rental Housing (PRH) and provision of subsidized home ownership. All such flats are small with average living space per person at around 11 square metres (or less). Older PRH estates are often conveniently located and even new estates normally have good public transport access. Rents typically average 10-15% of disposable income (with such income normally being below the taxable threshold<sup>85</sup>). Thus, the large majority of low income Hong Kong residents are comparatively sheltered from the on-cost impact of the land revenue system. A system exists, too, for passing on a PRH flat from one generation to the next, subject to a means test regime.<sup>86</sup> About 30% of Hong Kong residents live in PRH with about another 20% living in subsidized, privately owned housing.<sup>87</sup>

#### 4.5 The Residual Welfare State

Hong Kong Governments have historically been able to control expenditure quite effectively. Cultural-economic reasons provide an important part of the explanation for this. Briefly, Hong Kong people have long relied heavily on family and related networks to cope with a multitude of life’s exigencies. Moreover, from the 1960s until the 1990s, Hong Kong maintained high economic growth rates sustaining full employment. Also important was the long established reluctance of the Government to introduce more comprehensive programmes to tackle endemic social justice deficiencies within Hong Kong.<sup>88</sup>

This combination of factors meant that the Government was put under (and placed itself under) significantly less pressure to develop a ‘welfare state’ of the complexity typically

<sup>82</sup> Ibid. See also note 66.

<sup>83</sup> In 2010, it was said that over 70% of Hong Kong residents lived in flats smaller (some times very much smaller) than 700 square feet. Over 50% lived in flats of less than 500 square feet. See Leung, Chun-ying, ‘Does Hong Kong have the Policy Vision for the Coming Years’ (2010) (January) Hong Kong Journal available at: [http://www.hkjjournal.org/archive/2010\\_spring/1.htm](http://www.hkjjournal.org/archive/2010_spring/1.htm). (Mr Leung has been the Chief Executive of the HKSAR since July 1, 2012).

<sup>84</sup> Leung identifies this decent home access problem as a massively alienating challenge facing Hong Kong, *ibid*.

<sup>85</sup> About 60% of wage and salary earners fall outside the Salaries Tax net, see Section 4.3, above.

<sup>86</sup> See, Fung, Ping Yan, Statistics on Public Rental Housing of the Hong Kong Housing Authority, at: <http://www.legco.gov.hk/yr04-05/english/sec/library/0405in15e.pdf>.

<sup>87</sup> Hong Kong: The Facts, at: <http://www.gov.hk/en/about/abouthk/factsheets/docs/housing.pdf>. See, also, Public Housing in Hong Kong: Past Present and Future, at: [http://www.cih.org.hk/event\\_speaker\\_download/events2006100801/Public%20Housing%20in%20Hong%20Kong-%20Presentation%2024-9-06\(insert%20photo\).pdf](http://www.cih.org.hk/event_speaker_download/events2006100801/Public%20Housing%20in%20Hong%20Kong-%20Presentation%2024-9-06(insert%20photo).pdf).

<sup>88</sup> Goodstadt, *op. cit.* note 22.

encountered in most other developed economies. What evolved is a system which has been aptly described as the ‘residual welfare state’.<sup>89</sup> Hong Kong is characterized by a somewhat paradoxical combination of heavy public involvement in financing and provision of direct public goods, especially housing (see Section 4.4, above) plus educational and health and general infrastructures - while at the same time maintaining comparatively low overall government spending (compared to revenues).<sup>90</sup>

The rate of public welfare spending has been increasing, however. Hong Kong’s ageing population and rising social welfare expectations help explain a significant part of this growth.<sup>91</sup> It is in the area of transfer payments (direct payments by government to individual citizens) that welfare budgets in other developed countries have seen the greatest growth and where they typically exceed direct public welfare spending (on the likes of housing, schools and hospitals) significantly. Until the 1990s, Hong Kong was notable for its comparatively low level of transfer payments.<sup>92</sup> From the mid-1990s, welfare spending of all kinds (including transfer payments) began to rise in Hong Kong.<sup>93</sup> Since 1997, welfare spending has been cut back in Hong Kong.<sup>94</sup> Goodstadt argues that Hong Kong’s social spending policies have long been and remain deeply flawed – a position made all the more indefensible given the HKSAR’s massive Fiscal Reserves and familiarity with world-wide best practice.<sup>95</sup>

Another factor of importance in the provision of public welfare infrastructure is the Hong Kong Jockey Club (HKJC). The HKJC is a not-for-profit organisation which has long held a monopoly granted by the Government to run all legal gambling activities in Hong Kong. In 2011-2012 the HKJC had a turnover of around US\$18 billion.<sup>96</sup> The HKJC typically contributes over 10% of HKSAR Government revenues in the form of betting duties and other taxes.<sup>97</sup> Also significant is the major public spending programme of the HKJC based on its operating surpluses.<sup>98</sup> Hong Kong is dotted with hospitals, educational establishments and a substantial number of other public facilities all funded in full or in part by the HKJC.<sup>99</sup>

Hong Kong continues to experience major problems with poverty and income disparity. A 2007 report by the Hong Kong Council of Social Services showed that 20% of Hong

<sup>89</sup> Lee, Eliza, Wing-ye, ‘The Politics of Welfare Developmentalism in Hong Kong’, at: <http://www.unrisd.org/unrisd/website/document.nsf/0/B764A113DEE628D4C125706D0032DA66?OpenDocument>.

<sup>90</sup> Ibid.

<sup>91</sup> Ibid.

<sup>92</sup> In 1997, less than 5% of public expenditure was devoted to transfer payments in Hong Kong, whilst 50% of public spending went on direct health, welfare, education and housing infrastructure. In the US, at the same time, the comparable figures were around 33% and 22%, respectively. See, ‘It is already 1997 in Hong Kong’ *The Economist*, 18 December 1997, 27.

<sup>93</sup> One commentator has estimated that broad social welfare spending increased by a total, nominal, 236% between 1994 and 2004 (see, Dom, James A., *Economic Freedom Must Lead the Way in Hong Kong*, at: <http://www.cato.org/dailys/11-27-04.html>).

<sup>94</sup> Lee, op cit. note 89.

<sup>95</sup> Goodstadt, op. cit. note 22.

<sup>96</sup> See, 2011-2012 Season End Results-Hong Kong Jockey Club, at: <http://corporate.hkjc.com/corporate/operation/english/11-12-results.aspx>.

<sup>97</sup> See, Lovelock, Peter and Grant, Ken, *Hong Kong Chronicles*, at: <http://english1.e21times.com/asp/fd.asp?r=974>.

<sup>98</sup> See, *Strengthening Philanthropy in the Asia Pacific: An Agenda for Action – Background Paper: Hong Kong*, at: <http://www.asiafoundation.org/pdf/APPC.HK.pdf>.

<sup>99</sup> All of this expenditure has helped keep the Government’s own spending under control.

Kong people (well over 1 million residents) lived below the poverty line. By some measures, this figure has eased by a small margin since<sup>100</sup> – but it remains very high for a jurisdiction enjoying such a high per capita GDP (ranked 5<sup>th</sup> in the world).<sup>101</sup> The Gini-coefficient, which measures income inequality in a society (the higher the number, the greater the raw gap between rich and poor) was 0.525 in 2001, 0.533 in 2007 and 0.537 in 2011. This figure (for the HKSAR) is one of the highest in the developed world and is comparable to the wealth disparities in nations like Paraguay and Papua New Guinea. Comparable (World Bank) figures for the UK and the USA are 0.34 (2005) and 0.45 (2007), respectively.<sup>102</sup>

The most recent HKSAR Government, led by Chief Executive (CE), C. Y. Leung, took office on 1 July 2012. For the first time since the handover of British Hong Kong to China, in July, 1997, Hong Kong has a Government with a clearly prioritised social-justice platform. The policy agenda of the new Government is focussed, inter alia, on issues like basic housing, poverty reduction, environmental improvement and care for the aged. This is the most comprehensive and explicit social-justice platform presented in Hong Kong since the 1970s. Due to the controversial circumstances surrounding the 2012 CE ('small circle') election process and the above agenda, the new Government has encountered unrelenting criticism from much of the mass media. The new CE is seen to be far 'too close' to Beijing by Pan-Democrats. It appears he owes few if any debts to Hong Kong's dominant 'Big Money' and professional elites. The Plutocrats and the Pan-Democrats (and many in the mass media) seem often to find themselves sharing an embedded level of hostility towards the new CE (and his government – which includes some leading Pan-Democrats, as it happens). Notwithstanding the fact that the HKSAR currently finds itself more trapped than ever before in an uninviting period of severe negative politics, the Government has pressed ahead with its agenda. It is fair to expect that levels of government, public welfare spending are more likely to increase rather than decrease over the coming 5-10 years.<sup>103</sup>

<sup>100</sup> Professor Wong, Hung said that the figure for the overall poverty rate in 2010 was 18.1%, see Wong, Hong, Poverty in Hong Kong: An Overview, at: [http://web.swk.cuhk.edu.hk/~hwong/pubfile/presentation/201203\\_NA\\_Poverty\\_in\\_HK.pdf](http://web.swk.cuhk.edu.hk/~hwong/pubfile/presentation/201203_NA_Poverty_in_HK.pdf).

<sup>101</sup> See note 26 and accompanying text.

<sup>102</sup> See, List of Countries by Income Equality, at: [http://en.wikipedia.org/wiki/List\\_of\\_countries\\_by\\_income\\_equality](http://en.wikipedia.org/wiki/List_of_countries_by_income_equality). See also, Poverty in Hong Kong, Hong Kong Council of Social Services, at: [http://www.hkcss.org.hk/praecep/pov\\_rate\\_91-05.pdf](http://www.hkcss.org.hk/praecep/pov_rate_91-05.pdf). (This study also showed that the Gini-coefficient figure in the HKSAR in 2001 (0.524) was even higher than that applying in the Mainland PRC (0.447) in the same year.) See, too, Oxfam Advocates Legislation of Minimum Wage, at: <http://www.oxfam.org.hk/english/>. The HKSAR Government contends that raw Gini-coefficient figures can be misleading and that the real situation in Hong Kong is not as bad as that indicated by such figures. Moreover, it argues that, as an economy in transition to a largely knowledge and skills-based economy such figures are likely to be amplified (during the transition period). See: Chan, K. C., Gini-coefficient, Response to LegCo Question, by Prof. K. C. Chan, Secretary for Financial Services and the Treasury, 4 July 2007, at: <http://www.info.gov.hk/gia/general/200707/04/P200707040186.htm>. See, too, The Gini Coefficient of Hong Kong: Trends and Interpretations (2011), at <http://www.hkeconomy.gov.hk/en/pdf/box-12q2-5-2.pdf>.

<sup>103</sup> There is no space here to cover all the detail of the controversies surrounding the new HKSAR Government and what the implications and real risks could be for Hong Kong's political and economic destiny. A fairly wide range of comments following the CE's first policy address (on January 10, 2013) may be found at: <http://www.scmp.com/topics/cy-leung-policy-address-2013> (South China Morning Post). See, also: Lee, Peter, 'Maiden Policy Address a Step in the Right Direction' at [http://www.chinadaily.com.cn/hkedition/2013-01/17/content\\_16128757.htm](http://www.chinadaily.com.cn/hkedition/2013-01/17/content_16128757.htm). (Despite the fact that the

## 4.6 Synopsis

The paramount (overall-positive) policy idea is the continuing use of land, to this day, as a fundamental public revenue source.

Hong Kong's land-related revenue system has by most (but not all) measures proved to be a remarkable success. It has generated very substantial public revenues virtually from the creation of British Hong Kong in 1841.<sup>104</sup> It continues to do this today. As previously noted, in the Forward Estimates for 2013-2014, land revenue is estimated to be 16% of total Government revenues. Such revenues have exceeded 20% of total revenues in the relatively recent past. Several decades ago such income exceeded 30% of all Government revenues.

The land-related revenue system played a key role in building up very significant public reserves within 50 years of the founding of British Hong Kong. Today those reserves total well in excess of US\$300 billion. Around US\$85 billion are official Fiscal Reserves available, *prima facie*, for high-priority immediate spending by the Government. These Fiscal Reserves have been used, for example, to defend the HK Dollar most successfully (in 1997-98) and to fund significant deficit budgets over several years with zero recourse to borrowing.

The success of this land-based revenue system has always been driven by Hong Kong's remarkable economic success especially in trade and, until World War 1, by the trade in opium above all. Successive Hong Kong Governments have managed the system so as to maximize its revenue generating capacity. They have deliberately restricted the supply of land. They have also, historically, tightened the system so as to enhance and make still more secure, the Government core-interest in all land in Hong Kong.<sup>105</sup>

This, in turn, has notably encouraged the regular *re-development* of land originally released for residential, commercial and other uses. Because of the (highly conditional) leasehold system, any such redevelopment almost always requires the redeveloper to pay a lease modification premium to the Government. These continuing premium payments are rarely modest and can be very high indeed. This aspect of the system ensures that the Government continues to collect public revenues at regular (redevelopment) intervals based on enhanced land values, indefinitely.

From 1986, after the UK and the PRC signed the *Joint Declaration*,<sup>106</sup> land-based revenues were placed in a separately managed Land Fund Trust (presumably to ensure that the British did not spend these funds in ways not acceptable to Beijing, prior to the 1 July 1997 Handover).<sup>107</sup> In 1998, shortly after the Handover, the assets of the Land Fund were placed within the Exchange Fund to be managed in the same way as all other

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China Daily is an official, PRC English language newspaper, it enjoys a reputation for being more than a simple Chinese Communist Party mouthpiece. Mr Lee is Divisional President of CPA Australia, Greater China); and Lo, Alex, 'Just Who's Rainy Day is it Mr Tsang?' South China Morning Post, 2, 25 April 2013.

<sup>104</sup> The first land auctions were held in Hong Kong in 1841, the year the British first took possession of Hong Kong Island. That possession was formalized in 1842 when the Treaty of Nanking (see note 3).

See Webb, Part 1, *op. cit.* note 79.

<sup>105</sup> Webb, *ibid.*

<sup>106</sup> See note 3.

<sup>107</sup> See, Land Fund, at: [http://www.hkma.gov.hk/gdbook/eng/l/land\\_fund.shtml](http://www.hkma.gov.hk/gdbook/eng/l/land_fund.shtml).

Fiscal Reserves, by the Hong Kong Monetary Authority (HKMA).<sup>108</sup> Notwithstanding this relocation, Land Fund Reserves are ear-marked for capital works. They are transferred, for spending, in accordance with long-standing policy, into the Government's Capital Works Reserve Fund<sup>109</sup> (the HKMA manages this fund (along with all Government reserve funds (eight in total)) within the Exchange Fund).<sup>110</sup>

Another notable feature of the land-based revenue system is the way in which it has operated in an open way, largely free of serious corruption. Given the immense sums involved, this is an important achievement. The predominantly 'clean' market-driven operation of the system has been another key to its success. A combination of factors explains this outcome. There is no space here to detail them. In summary, the role of Hong Kong's Independent Commission Against Corruption (ICAC) has been significant. It is also the case that the system has been built so that most all stakeholders have developed a vested (financial) interest in maintaining its basic integrity.

The ICAC was established in 1974 as a very well resourced, fully independent anti-corruption authority. As the ICAC explains:

Hong Kong was in a state of rapid change in the sixties and seventies. The massive growth in population and the fast expansion of the manufacturing industry accelerated the pace of social and economic development. The Government, while maintaining social order and delivering the bare essentials in housing and other services, was unable to satisfy the insatiable needs of the exploding population. This provided a fertile environment for the unscrupulous. In order to earn a living and secure the services which they needed, the public was forced to adopt the 'backdoor route'. 'Tea money', 'black money', 'hell money' - whatever the phrase - became not only well-known to many Hong Kong people, but accepted with resignation as a necessary evil.<sup>111</sup>

In 2012, the HKSAR maintained its strong reputation for a low corruption jurisdiction ranking 14<sup>th</sup> in the Transparency International Corruption Perception Index, ahead of both the USA and the UK.<sup>112</sup>

<sup>108</sup> See, History: Establishment of the Exchange Fund, at <http://www.hkma.gov.hk/eng/key-functions/exchange-fund/history.shtml>. See, also, note 51.

<sup>109</sup> See, Loh, Christine, Recurring Problem, at: [http://www.civic-exchange.org/wp/wp-content/uploads/2011/01/110114\\_SCMP.pdf](http://www.civic-exchange.org/wp/wp-content/uploads/2011/01/110114_SCMP.pdf).

<sup>110</sup> Cheung, Tony, 'Calls for Government to limit size of Fiscal Reserve', South China Morning Post, February 19, 2013, at: <http://www.scmp.com/news/hong-kong/article/1153362/calls-government-limit-size-fiscal-reserve>.

<sup>111</sup> See <http://www.icac.org.hk/eng/about/index.html>. Hong Kong was strongly influenced, in its move to establish the ICAC, by the earlier, successful, experience of Singapore in drastically reducing corruption (see Goodstadt, Leo G. *Uneasy Partners: the Conflict Between Public Interest and Private Profit in Hong Kong* (Hong Kong University Press, Hong Kong, 2005) 141. For a detailed review of the history, achievements and challenges facing the ICAC, see, Cullen, Richard, Yang, Xiaonan and Loh, Christine, 'Executive Government' in (Chan and Lim (eds.)) *Law of the Hong Kong Constitution* (Sweet & Maxwell, Hong Kong, 2011) Chapter 9.

<sup>112</sup> Corruption Perceptions Index 2012, at: <http://www.transparency.org/cpi2012/results#myAnchor1>. See, also ICAC Post, March, 2012, at: [http://www.icac.org.hk/filemanager/en/Content\\_1025/post1202.pdf](http://www.icac.org.hk/filemanager/en/Content_1025/post1202.pdf).

This comparatively low corruption environment has been very good both for doing business and living life, for ordinary residents. Business and ordinary residents are both firm supporters of the HKSAR's low rate, minimalist Income Tax system.<sup>113</sup> The second significant positive lesson which Hong Kong offers is, thus, that it is possible to maintain, in the modern era, a highly effective revenue regime which is minimalist, clear and easy to comply with. This second positive example depends greatly on the first policy innovation (although other factors also are important).

The success of this evolved-innovation also underpins the primary, bad aspects of the HKSAR RR, however. Two examples stand out: notable revenue policy inflexibility; and the high on-cost effects of the land-based, revenue system.

Briefly, habits of wariness about long-term Revenue Policy planning shared over many decades by both Government and, especially, big business and its advisors are well entrenched in the HKSAR.<sup>114</sup> On the positive side, many argue with some cogency, that the long-term, 'keep it simple' approach has worked so remarkably well, there is no need for complex forward planning in this area. This perspective is reinforced by the view that the time-proved, preeminent mode of planning for the future is to save with gold medal vigour, which is just what Hong Kong has always done. Less positively, such planning is seen as a trigger for enhanced public expenditure designed to shift Hong Kong away from its residual welfare state model.

The land-based revenue system means that the effective monopoly supplier of land, the Government, has a powerful vested interest in maintaining high land prices. Two of the most clear adverse, on-cost consequences of this are: high (often very high) entry prices to achieve any sort of home ownership; and an inflation impact on the provision of most goods and services due to the high costs of renting or buying business premises.

A major housing crisis has been avoided, though, above all by the Government building Public Rental Housing (PRH) and subsidized owner occupied housing<sup>115</sup> on a massive scale. This programme began in earnest in the mid-1950s after a major fire in a squatter settlement in Shek Kip Mei left some 50 000 people homeless in December, 1953. It gained real momentum in the early 1970s when the Government announced plans to house or re-house around 2 million people within 10 years.<sup>116</sup> All these flats are small (or very small) typically providing less than 50 square feet to house a growing family. But the Housing Estates are typically well run, well maintained and generally safe for tenants of all ages. The most poorly located are in remoter districts but they still usually have good public transport access. The many well located Estates are close to all facilities including the excellent and extensive Mass Transit Railway (MTR) system.

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<sup>113</sup> Cullen, Richard and Simmons, Richard, 'Tax Reform and Democratic Reform in Hong Kong: What do the People Think?' [2008] *British Tax Review*, 667.

<sup>114</sup> The fundamental policy-setting alliance between Hong Kong's business and professional elites and the Government during the entire period of British rule in Hong Kong is extensively documented in Goodstadt, Leo F., *Uneasy Partners; The Conflict Between Public Interest and Private Profit in Hong Kong* (Hong Kong University Press, Hong Kong, 2005).

<sup>115</sup> Since 1978, over 465,000 subsidized flats have been sold to low and middle income households in Hong Kong, see, Hong Kong: The Facts, September 2012, at: <http://www.gov.hk/en/about/abouthk/factsheets/docs/housing.pdf>.

<sup>116</sup> Fung, Ping Yan, Statistics on Public Rental Housing of the Hong Kong Housing Authority, at: <http://www.legco.gov.hk/yr04-05/english/sec/library/0405in15e.pdf>.

Once the Government had settled on this policy, it was able to provide all the necessary land for building without any direct acquisition costs. Moreover, the land-based revenue system was a major factor in helping to fund this massive new building programme.

The Hong Kong Housing Authority, created in 1972, remains the primary body responsible for running this system and for building new public housing. The Housing Authority estimated total capital expenditure for the 2013-2014 financial year at US\$1.5 billion approximately. Total cash and investment reserves for the Housing Authority at the close of the same year are estimated at US\$8 billion.<sup>117</sup> Annual production of new Housing Authority rental flats ranges from 13 000 to 20 000 over the four year period from 2012.<sup>118</sup> The total stock of existing PRH flats is over 760 000.<sup>119</sup>

The very high densities of residential accommodation in Hong Kong (public and private) have been fostered significantly by the land-based revenue system. By restricting land supply, the Government has husbanded its 'land bank' and helped ensure the best price for all released land (and high redevelopment premiums). This system has also ensured that residents enjoy one of the very best, low cost public transit systems in the world. Moreover, communications systems are first rate and access to health, hospital, educational, recreational and shopping etc facilities are also highly regarded. A further advantage is that almost all Hong Kong residents live within a relatively short, regular-service bus ride to hillside country parks. Beaches are readily accessible, too.

The higher costs of service provision noted earlier, arising from the land-based revenue system are also offset in a number of ways. The MTR system subsidizes its transport service through development rights it enjoys which are typically linked to newly built MTR lines and stations. The very high densities (and low car usage due to high garaging costs, inter alia) help build in viability for the extensive bus, mini bus and taxi networks. The Government also subsidizes all bus and taxi services through fuel excise relief mechanisms.

The lack of any need to pay direct taxation for thousands of small businesses (and their employees) also helps to keep costs down for consumers – the majority of whom also pay no direct taxes.

So far, so good, one might say. The serious problem is that, right now and especially looking forward many major public policy challenges face the HKSAR.

Hong Kong's new Chief Executive, C. Y. Leung (from 1 July 2012), identified a range a major challenges in a policy review article he published in early 2010.<sup>120</sup> His Government is the first since the handover of British Hong Kong to China, in July, 1997

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<sup>117</sup> Housing Authority Budgets 2013-2014, at: <http://www.housingauthority.gov.hk/mini-site/budgets1314/en/view.html?f=5>.

<sup>118</sup> Forecast Public Housing Production 2012/13 to 2016/17, at: <http://www.housingauthority.gov.hk/en/about-us/publications-and-statistics/forecast-public-housing-production/index.html>.

<sup>119</sup> Hong Kong: The Facts, September 2012, at: <http://www.gov.hk/en/about/abouthk/factsheets/docs/housing.pdf>.

<sup>120</sup> Leung, Chun-ying, Does Hong Kong Have the Policy Vision needed for the Coming Years, at: [http://www.hkjjournal.org/archive/2010\\_spring/1.htm](http://www.hkjjournal.org/archive/2010_spring/1.htm).

to offer a clearly prioritised social-justice platform. This policy agenda is focussed, above all, on issues like basic housing, poverty reduction, environmental improvement and care for the aged. Not since the 1970s, when the British set about building public housing on a massive scale (and created the ICAC) has Hong Kong seen such an explicitly activist Government.

The reasons for Hong Kong to undertake an in-depth and comprehensive review of Revenue Policy have been evident for some years. The pressures to do so, not least coming from within the new Government itself, are now intensifying. The extraordinary fiscal fitness of the HKSAR Government offers a remarkable opportunity to address existing and coming policy challenges innovatively and effectively - without immediately having to worry about where the money is coming from. This same rude financial health underpins serious policy inertia, too, unfortunately.

## 5. CONCLUSION

The discussion so far has set out key aspects of the development of Hong Kong's rather usual public revenue profile. It has also argued what the primary positive and negative aspects of that revenue system are and how they have come to be as they are.

In this Part, I first consider what principles can be argued to underpin the crucial defining factor in the HKSAR's RR; the continued conspicuously heavy reliance, since 1842, on a land-based revenue system. Next, I argue why this aspect of the RR may have lessons beyond Hong Kong – and how such lessons might be acted upon, especially in urban areas.

### 5.1 Land as the common heritage of humanity

It would seem that in most all major developed jurisdictions, economically valuable, surface real estate (not least central urban real estate) has been alienated, over the course of time, by the State through some form of absolute or near-absolute sale or disposal.<sup>121</sup> Even in the UK, on which Hong Kong has based its leasehold mode of land 'sales', the underlying title – the 'Landlord's Title' – is now, in urban areas, either 'freehold' (owned by the occupier) or the lessor interest is in private hands or owned by the Crown Estate.<sup>122</sup> Leasehold interests give leaseholders significantly more rights than those enjoyed in Hong Kong. State, ultimate ownership of land in the UK, especially in urban

<sup>121</sup> Cahill, Kevin, 'Who Owns the World', *New Statesman*, 17 March, 2011, available at: <http://www.newstatesman.com/print/global-issues/2011/03/land-queen-world-australia>.

<sup>122</sup> The Crown Estate is an extensive property portfolio in the UK owned by the Monarch in the name of Crown. It is no longer the private property of the reigning Monarch and cannot be sold by him/her, nor do the revenues from it belong to the Monarch personally (as each Monarch, upon accession, surrenders the surplus revenues to the Treasury in return for an annual grant known as the Civil List. The entire portfolio is managed (commercially and for the public (beaches etc)) by an organization known as The Crown Estate, headed by the Crown Estate Commissioners. By 1760, when George III came to the throne, taxes had become the major source of revenue (rather than land held by the Monarch). From that time, the Monarch gave up rights to all revenues from Crown Lands in return for the agreed a fixed annual payment (today called the Civil List). See, *The Crown Estate: Our History*, at: <http://www.thecrownestate.co.uk/about-us/our-history/history/>.



areas, is now minimal having shrunk significantly during the period of Conservative Government (1979-1997).<sup>123</sup>

At the heart of the land-based revenue system in Hong Kong is the fact that all Hong Kong Governments since 1842 to the present day have retained a core proprietary interest in virtually all real estate in Hong Kong. As we have seen above, this policy has emerged initially from practical concerns about basic public financing of the new colonial outpost (influenced by lessons learned from the British, North American colonial experience). As it proved its worth, it has been developed further – and entrenched. There has never been any real outcry about this retention of core Government proprietary interests, even from very large and powerful private owner-stakeholders. Key explanations for this private-stakeholder support would appear to be that, over time, the system has proved, if anything, even more beneficial to private landholders in terms of gains in value (and scope to trade in land profitably), plus it has ensured the retention of a low rate, simple Tax System which finds favour across almost all interest groups in Hong Kong.

At a pragmatic policy level, the land-based revenue system has clearly proved itself - drawbacks (outlined above) notwithstanding. But such a system can also be strongly justified in principle.

The work of Henry George, the American economist who favoured a single tax on land has already been mentioned.<sup>124</sup> His economic arguments have had some limited influence and have also been subject to significant criticism.<sup>125</sup> His argument that land is part of the ‘common heritage’ of humanity<sup>126</sup> has a coherence which is easily overlooked, however, in jurisdictions where almost all land of economic value has been alienated by the State. (This alienation has not happened in all jurisdictions, of course – and it has not happened in Hong Kong.)

More recently, some Property Law theorists have argued that individual ownership of land, especially, is qualified by a powerful ‘social-obligation norm’. This concept stresses obligations owed (by property owners) to other members of various communities. This concept can also be employed to stress that such obligations can be met by conceding rights to the State to hold core proprietary interests in land for the purpose of protecting and enhancing community interests. (At a practical-political

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<sup>123</sup> Home, Robert, ‘Land Ownership in the United Kingdom: Trends, Preferences and Future Challenges’ (2009) Land Use Policy, 103, available at: [http://www.bis.gov.uk/assets/foresight/docs/land-use/jlup/12\\_land\\_ownership\\_in\\_the\\_united\\_kingdom\\_-\\_trends\\_preferences\\_and\\_future.pdf](http://www.bis.gov.uk/assets/foresight/docs/land-use/jlup/12_land_ownership_in_the_united_kingdom_-_trends_preferences_and_future.pdf).

<sup>124</sup> See note 21. See, also: George, Henry, *Progress and Poverty*, (Kegan Paul, Tench & Co., London, 1886 (reprinted)); and Backhaus, Jurgen G., ‘Henry George’s Ingenious Tax: A Contemporary Restatement’ (1997) 56 *American Journal of Economics and Sociology*, 453.

<sup>125</sup> For a recent summary of this criticism, see Hudson, Michael, ‘Henry George’s Political Critics’ (2008) 67 *American Journal of Economics and Sociology*, 1. (Also available at: <http://michael-hudson.com/wp-content/uploads/2010/03/0801GeorgesCritics.pdf>.)

<sup>126</sup> ‘The equal right of all men to the use of land is as clear as their equal right to breathe the air—it is a right proclaimed by the fact of their existence. For we cannot suppose that some men have a right to be in this world, and others no right.’ George, *Progress and Poverty*, op. cit. note 124.

level, this is particularly so when the State has retained significant rights over most or all land in a given jurisdiction).<sup>127</sup>

As the discussion above has shown, modifications to Hong Kong's land-based revenue system are warranted generally and also because it has produced certain troubling side-effects. Notwithstanding these concerns, there remains a strong, in principle argument, that the retention of a core proprietary in all land by Government is (and has proved to be) fundamentally in the public interest; this core-interest is retained, ultimately, for the benefit of all Hong Kong residents.

As it happens, Governments in numbers of developed jurisdictions, which have allowed the full or near complete alienation of surface rights of economically valuable land – particularly in urban and near-urban areas - have moved to retain ownership or economic control of sub-surface rights (mineral rights, service-tunnelling rights etc).<sup>128</sup> Here too, the justification is often put in terms of Government acting to preserve a common heritage.<sup>129</sup>

## 5.2 State retention of a core proprietary interest in land – policy realities

First, we should reconsider some key elements – outside of the revenue collection system itself – which have helped ensure the remarkable success and durability of the land-based revenue regime in Hong Kong.

The Hong Kong Government has dealt effectively with the immediate housing-crisis threat posed by such a system, particularly when it is premised on a high-density, high-price model. The massive intervention of the Government into the market through the

<sup>127</sup> Professor Alexander puts it this way: 'Private property ordinarily triggers notions of individual rights, not social obligations. The core image of property rights, in the minds of most people, is that the owner has a right to exclude others and owes no further obligation to them. That image is highly misleading. Property owners owe far more responsibilities to others, both owners and non-owners, than the conventional imagery of property rights suggests. Property rights are inherently relational, and because of this characteristic, owners necessarily owe obligations to others. But the responsibility, or obligation, dimension of private ownership has been sorely under-theorized. Inherent in the concept of ownership is an implicit norm that might be called the social-obligation norm. This norm captures the various obligations that owners owe to others, specifically, to certain members of the various communities to which they belong. The moral foundation of this norm is human flourishing. As a moral and legal value human flourishing differs importantly from welfare as that term is commonly used today by economists and legal analysts.' (Abstract of Lecture delivered to the Faculty of Law, Hong Kong University, 15 April 2013. See, also, Alexander, Gregory S. and Penalver, Eduardo M., *An Introduction to Property Theory* (Cambridge University Press, Cambridge, 2012).

<sup>128</sup> In Australia for example, Crown rights to all gold were proclaimed in NSW and Victoria in 1851 shortly after gold was discovered. Statutory Crown claims to rights over all (onshore) minerals in all Colonies (later States) followed. Once the Commonwealth (Federal Government) was established it too made similar claims, especially in the offshore, in the 1970s. (Cullen, Richard, *Federalism in Action* (Federation Press, Sydney, 1990). Crown rights over minerals (onshore and offshore) in Canada are also extensive, see Cullen, *ibid* and Thompson, Andrew R., 'Resource Rights', *The Canadian Encyclopedia*, at: <http://www.thecanadianencyclopedia.com/articles/resource-rights>.

<sup>129</sup> 'Julia Gillard told a dinner hosted by the council last night that Australians deserved to benefit from the mining boom - and that the nation's resources belonged to its people and not the government or mining companies. Mr Hooke [Head of the Minerals Council of Australia] said Ms Gillard's remarks were well received - and that the industry had never contested the fact the sovereign state owned the minerals.' Baker, Mark, 'The Boom is not Yours, PM tells Miners' *Sydney Morning Herald*, 31 May 2012, at: <http://www.smh.com.au/opinion/political-news/boom-is-not-yours-pm-tells-miners-20120530-1zjfb.html>.

supply of low-cost public housing has been vital to the success of the system. It has done this by building (and continuing to build) Public Rental Housing on a vast scale and by subsidizing the means-tested purchase of owner-occupied housing by the less-wealthy, accounting (in combination) for around 50% or all housing in Hong Kong, still.

The high density (public and private) housing model has resulted in smaller living spaces – but it has also enabled provision of world-class, low-cost public transport and communication services coupled with, usually, good-excellent access to all services, including schools/education, health care/hospitals, recreational amenities and excellent shopping facilities. This development model also facilitates easy access to extensive country parks and other green areas for residents, which is hard to find in any other city of comparable size.

Next, the model has been developed so that most all the stakeholders have come to see that they have a vested interest in maintaining the governance-integrity of the system. The very effective work of the ICAC, constantly ‘riding shotgun’ around the system (for around four decades, now) has helped significantly in convincing players – and maintaining their perception – of this vested interest.<sup>130</sup> This ‘must-have-stick’ has been deeply supported by the ‘carrot’ of the low rate, simple Tax System, which has significant roots in the land-based revenue regime. Within this framework, an often pulsating free market normally operates at both wholesale (developer) and retail levels – ensuring market mechanisms largely remain vital in allocating scarce land resources.<sup>131</sup>

That part of the very significant Fiscal Reserves referred to as the Land Fund of the Hong Kong Government, currently suffers from being too restricted in terms of how they may be spent. What is clear, however, is that they have never been allowed to become a general ‘Slush Fund’, still less, a ‘Rolex Reserve Fund’ – that is a fund the use of which systemically lacks transparency the better to allow industrial-scale, organized political pocket-lining.

Finally, the British had established a pattern of sound training, pay and career path opportunities for its Colonial Civil Service by the early 19<sup>th</sup> century. This policy

<sup>130</sup> ‘In an astonishing scene in a Hong Kong courtroom on Friday, Sun Hung Kai Property (SHKP) co-chairmen and managing directors Thomas Kwok Ping-kwong, 60, and Raymond Kwok Ping-luen, 58, were charged under the bribery ordinance, as was the top official they are accused of bribing, former chief secretary Rafael Hui Si-yan, 64. According to ICAC investigators, from 2000 to 2009, the Kwok brothers provided a rent-free luxury apartment and nearly HK\$35 million (US\$4.5 million) in kickbacks to Hui; meanwhile, SHKP-Hong Kong’s (and perhaps Asia’s) biggest developer, which employs more than 27,000 people, was allegedly the beneficiary of one sweet government favor after another.’ Ewing, Kent, ‘Landmark Corruption Trial Looms in Hong Kong’ Asian Times Online, 17 July 2012, at: <http://atimes.com/atimes/China/NG17Ad01.html>.

<sup>131</sup> The HKSAR has also had the most direct experience of collapsing (70% drop in values on average) real property market spread over several years, see note 61. Government sales on ‘favoured terms’ are also not unknown. The Government land (and related) deals to encourage the establishment of ‘Hong Kong Disneyland’ and ‘Cyberport’ (plus land-development opportunities / subsidies provided to privately run utilities) are examples. See, Loh, Christine, ‘How the Hong Kong Government Makes Decisions,’ CLSA Emerging Markets Report (September, 2000), at: [http://www.civic-exchange.org/wp/wp-content/uploads/2010/12/200009\\_HKGovMakesDecision.pdf](http://www.civic-exchange.org/wp/wp-content/uploads/2010/12/200009_HKGovMakesDecision.pdf). See, also, Ng, Kang Chung, ‘Hong Kong Disneyland’s Fairy Tale had a Wicked First Chapter’, South China Morning Post (19 February 2013) at: <http://www.scmp.com/news/hong-kong/article/1153359/hong-kong-disneylands-fairy-tale-had-wicked-first-chapter>.

approach served Hong Kong comparatively well from the outset.<sup>132</sup> This strategy for limiting systemic, high level (and later, all-level (with the help of the ICAC)) public corruption was maintained and continues to be maintained in Hong Kong – it is an important component in the achievement of continuing low-corruption scores on international comparative studies.<sup>133</sup>

### 5.3 State retention of a core proprietary interest in land – policy possibilities

First, we should note some basic parameters and some clear human development trends. Total World population reach 7 billion in 2011. Although population growth has slowed somewhat, it is still expected to reach 8 billion by 2025 and over 9 billion by 2050.<sup>134</sup> In the early 20<sup>th</sup> century, 20% of the World's population lived in urban areas. By 1990, the figure was less than 40%. By 2010, it exceeded 50%. By 2050, it is estimated that 70% of the World's population will be urbanized.<sup>135</sup>

This massive shift to urban living, across the World, can clearly only be achieved with some measure of success for those involved if intelligent Government planning and management apply. It equally follows, in the view of many, that these massive changes in the way most people live, will have to rely heavily on high to very high density living, not least to limit the 'carbon footprint' impact of these changes.<sup>136</sup>

I believe that these future urbanisation assumptions are basically sound. The potential relevance (of the full operational aspects) of the Hong Kong model of very high density urban development (built, as it is, on the land-based revenue-pivot of the Hong Kong Revenue System) are also clear.

In the developed jurisdictions of the World, the opportunities to apply lessons drawn from Hong Kong are greatly limited because of the long-term transfer of land – and particularly urban land – almost entirely, *prima facie*, into private hands.

In the developing jurisdictions of the World this drawback may or may not apply. In particular, this (dominant) private-ownership shortcoming does not apply in Mainland China. Since the establishment of the PRC in 1949, all ultimate ownership of land

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<sup>132</sup> Tso, Kevin, 'Fundamental Political and Constitutional Norms: Hong Kong and Macau Compared' (2012) 13 Australian Journal of Asian Law, available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2159544](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2159544). There are always exceptions to (which help prove, one hopes) the rule. Former HKSAR Chief Secretary, Raphael Hui has now been charged with corruption in relation to certain property development deals (see note 130). His base salary when in Government employment (before significant benefits) was around US\$300,000 per annum. It is said that Hui had developed a serious (non-successful) gambling habit. Details of the (often very generous) salaries paid across the HKSAR public sector (including to the police) can be found at: Note For [Legislative Council] Finance Committee: 2012-2013 Civil Service Pay Adjustment, <http://www.legco.gov.hk/yr11-12/english/fc/fc/papers/f12-49e.pdf>.

<sup>133</sup> See note 112.

<sup>134</sup> See, Current World Population, at: <http://www.worldometers.info/world-population/>.

<sup>135</sup> See, 'Urban Population Growth', World Health Organization, at:

[http://www.who.int/gho/urban\\_health/situation\\_trends/urban\\_population\\_growth\\_text/en/](http://www.who.int/gho/urban_health/situation_trends/urban_population_growth_text/en/).

<sup>136</sup> See, for example: Mensel Mensel, 'Cities are Making us More Human (Interview with Prof. Edward Glaeser (Harvard))', The European, December 20, 2011, at: <http://www.theeuropean-magazine.com/420-glaeser-edward/421-humans-cities-and-the-environment>; and Owen, David, 'Greenest Place in the US? It's Not Where You Think' Yale Environment 360, 26 October 2009, at: [http://e360.yale.edu/feature/greenest\\_place\\_in\\_the\\_us\\_its\\_not\\_where\\_you\\_think/2203/](http://e360.yale.edu/feature/greenest_place_in_the_us_its_not_where_you_think/2203/).

(urban and non-urban) has passed into the hands of the State – or its formal offspring (Rural Collectives, State Owned Enterprises, Municipalities, etc).<sup>137</sup>

The complex tensions – and abuses of (land grabbing) power – in the PRC since the first moves to ‘privatize’ (to a degree) land-usage rights following the commencement of Deng, Xiaoping’s major economic reforms in 1978 have created immense ongoing political, social and economic problems.<sup>138</sup> At the same time, new urbanization on an unprecedented scale has also been achieved and is ongoing.<sup>139</sup> China had less than 11% of its population living in urban areas when the PRC was established in 1949. By the time Deng’s ‘opening up’ reforms commenced, in 1979, that figure was still under 19%. Today over 50% of all citizens live in urban areas in China and by 2030, it is expected that China may have 1 billion urban residents.<sup>140</sup>

The post-Deng land reforms which have underpinned this vast shift from non-urban to (typically) high density urban living are significant in this discussion. What private land-holders enjoy, largely, in the PRC today, are ‘land use rights’ nominated for periods of between 40-70 years.<sup>141</sup> One pays a purchase price for these now normally transferable rights – and mortgage purchase-loans are fundamentally secured against these rights. The State ultimately holds the core interest in the relevant land. Rights (and modes) of ‘lease’ renewal remain less than clear.<sup>142</sup>

In short, this means that in China, given the retention of the core-title by the State, there is real potential to apply much of what Hong Kong has tested and has shown to work in terms of retaining land as a fundamental and significant, long-term source of public revenue.

Already, however, we have seen in China what massive potential there is for corruption and social disruption in the process of development-land acquisition and disposal of wholesale (especially) land-usage rights.

What the Hong Kong experience shows, is that for land-based revenue system to function with the greatest effectiveness (over the long-term) you need for Government to retain a core proprietary interest in all land. Also Government needs to stipulate very specifically what building/usage rights are permitted in each lease – so that redevelopment, often decades later, can be approved, subject to Government drawing on new revenues resulting from agreed lease changes. But this is far from enough. Government also needs: to address directly (and very effectively) the inevitable, amplified need for low-cost public rental and subsidized owner-occupied housing; and to put in place a raft of full-bodied measures to address the many civil and criminal

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<sup>137</sup> Ding, Chengri and Gerrit Knaap, ‘Urban Land Policy Reform in China’ (2003) 15 Land Lines, at: [http://www.lincolnst.edu/pubs/793\\_Urban-Land-Policy-Reform-in-China](http://www.lincolnst.edu/pubs/793_Urban-Land-Policy-Reform-in-China). Land Lines is published by the Lincoln Institute with its headquarters at the University of Hartford in Connecticut in the US. The institute was the creation of John C. Lincoln, a Cleveland industrialist, in 1946, who was, in starting the Institute, inspired by the written work of Henry George (see, About the Lincoln Institute of Land Policy, at: <http://www.lincolnst.edu/aboutlincoln/>).

<sup>138</sup> Ding and Knaap, Ibid.

<sup>139</sup> Ibid. See, also, Page, Jeremy, Davis, Bob and Areddy, James T., ‘China Turns Predominantly Urban’ Wall Street Journal, 18 January 2012, at: <http://online.wsj.com/article/SB10001424052970203735304577166652002366514.html>.

<sup>140</sup> Page et al, *ibid*.

<sup>141</sup> Ding and Knaap, *op. cit.* note 137.

<sup>142</sup> Ibid.

fraud and related hazards such a system generates. But if you can put in place a robust and comprehensive governance and market framework, this sort of system works. It can deliver decent, basic housing, potentially for all, and back that up with significant, long-term public fiscal benefits. It is hard to see an alternative, better, tried and tested model, which could help cope with the consequences of the coming vast, world-wide urbanization in a more practical and humane way. That is, where adopting a Hong Kong style model is still legally and politically possible.

# Crossed lines: two cases of tax policy incoherence

Sheila Killian<sup>1</sup>

## **Abstract**

This paper explores policy incoherence in a corporate tax context, using two examples from Ireland to illustrate different ways in which it can be manifest. The first case shows how aspects of Ireland's competitive tax regime are incoherent with the objectives of the country's overseas development aid. The second example describes how a domestically-focused anti-avoidance measure formed the bedrock of a multi-billion aircraft finance industry with considerable loss of revenue to the state. The two cases suggest that tax policy incoherence can arise from hegemony and aggressive tax planning, as well as from the more widely-studied dominant lobbyists.

## **1. INTRODUCTION**

Policy coherence may be defined, following Blouin (2007, p169), using the OECD definition of policy coherence as 'a process through which governments make efforts to design policies that take account of the interests of other policy communities, minimize conflicts, maximize synergies and avoid unintended incoherence'.<sup>2</sup> Less ambitiously, it could be simply characterized as the absence of crossed lines, those accidental ways in which policies in different areas, such as health and development, or tax and welfare contradict each other or render each other less effective. Even this basic 'absence of incoherence' can be difficult to achieve, and requires active policy management. However, despite the challenges, such active management is a reasonable expectation on the part of the general population; this is in a way the essence of governance, and the goal of minimizing policy incoherence serves efficiency in government, and effectiveness in delivery of the social contract.

Beyond this basic expectation of policy management, in the case of policies around overseas development aid, Ashoff (2005) observes that the case for policy coherence derives further legitimacy from a range of international structures and treaties including

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<sup>2</sup> OECD (200, p17).

commitments made by under the UN Millennium Development Goals, the Maastricht and Amsterdam treaties,<sup>3</sup> various OECD frameworks, etc. More fundamentally, there is also a pressing moral obligation to avoid creating negative externalities in the Global South, which frequently arise as a consequence of economic policies designed without regard for how they might conflict with development issues elsewhere.

Given the overriding case for policy coherence, the question arises as to what causes the lines to cross, and policies to become mutually ineffective? Blouin (2007) notes that policies are especially vulnerable to incoherence when a small, cohesive group of actors have the potential to share large benefits at the expense of a more marginal advantage that might otherwise accrue to a larger, more diffuse group of minority stakeholders. The tighter, better-organised group is in a better position to influence policy than a diffuse and less immediately interested population. This is essentially a version of the *cui bono*, the principle that the probable cause of an event can be detected by establishing who has gained. In cases where persistent or systematic policy incoherence arises, this principle calls into question the commitment of the government or governments to supporting the disadvantaged policies which may favour or protect more marginalized constituencies, and raises the possibility of a more powerful grouping dominating the national agenda. Despite its technical nature, there is no reason to assume that tax policy should be any less political than other national policies. There is also an element of chaos in how tax policies are implemented: the interaction of a complex and ever-changing set of variables which overlap in unexpected ways. As noted by Bird (2013):

... tax policy is shaped not only by ideas but also by vested interests, changing economic conditions, administrative constraints and technological possibilities, and, especially, by the nature and functioning of the political institutions within which these factors affect policy decisions. (Bird 2013, p9)

While considerable work has been done on the internal consistency and coherence of policies of tax and welfare on a national level, or of aid and trade internationally, far less attention has been paid to date to the impact of tax policies on the welfare of the population of other countries. Perhaps this is because, on one level, the ability to set tax policy is a cornerstone of nationhood, making tax the most domestically-focused and sovereign of fields. On the other hand, the power of multinational firms to create arbitrage opportunities by exploiting mismatches between the domestic tax systems of countries has been well documented recently, and the international impact of global tax evasion and avoidance is being addressed by bodies such as the UN, EC and OECD.

This paper highlights two cases of Irish tax policy incoherence. The first is perhaps the more straightforward and far-reaching, involving a conflict between the Irish policies of tax competition and overseas development aid. The second is more domestically-centred and focused on the unexpected exploitation of an anti-avoidance measure which led to the development of a multi-billion pound aircraft finance industry in the 1980s now turning over an estimated \$20 billion per year (Gill 2013). The principle of *cui bono* is less clear in these examples than in other studies on the topic and there is far less obvious national self-interest at play. The juxtaposition of these two examples raises the idea that tax policy incoherence can arise from other causes, including a

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<sup>3</sup> See Carbone (2008) for a comprehensive overview of EU commitments to policy coherence in the field of overseas development aid.



hegemonic acceptance of tax rules, and aggressive tax planning by taxpayers and their advisors.

Ireland is an interesting jurisdiction with which to explore these issues for three reasons. Firstly, it has been exceptionally consistent about its corporate tax policy, with a clear single-minded tax focus on attracting foreign direct investment. Secondly, it has an equally clearly-stated commitment to overseas development aid. Thirdly, its success in attracting foreign direct investment means the impact of its policies can be tracked internationally more clearly than, for example, those of a larger economy such as the US or the UK. For these reasons, the country provides an exceptionally clear set of cases which interact in an interesting way.

## 2. IRELAND'S TAX HISTORY

As outlined in Killian (2013) Ireland's tax policy has, since the mid-1950s, been steered towards the attraction of foreign direct investment. Since the introduction in Ireland of Corporation Tax in 1976, special reduced rates applied to exporters and manufacturing firms, which at the time were overwhelmingly foreign-owned. Export Sales Relief (ESR) applied a tax rate of 0% to the profits on goods made in Ireland and exported from the country expired in 1990, and was widely availed of by multinationals locating manufacturing and exporting subsidiaries in Ireland. Parliamentary records show that the cost of tax foregone to Ireland from profits on exported goods came to approximately £337 million<sup>4</sup> per year in the late 1980s (Oireachtas 1988), but the strategy was successful in making Ireland an attractive location for foreign direct investment. At this time, the zero rate also applied to a designated zone around Shannon Airport in the South West, provided the companies located there were licenced by the government to avail of what was known as 'Shannon Relief'. When ESR expired, it was succeeded by Manufacturing Relief, which reduced the tax on profits from the sale of manufactured goods to 10%, a fraction of the rate applying at the time to non-manufactured goods. Because of the liberal court interpretation of the meaning of 'manufactured', the latter relief applied to a wide range of processes including, famously, the artificial ripening of fruit, the grading of coal and the inclusion of a red dye in commercial diesel. At around this time, a 10% rate also applied to Shannon companies, and to financial services firms operating in the International Financial Services Centre on Dublin's docklands.

Towards the end of the 1990s, Ireland came under increased pressure from the EU, to abolish these favourable tax rules. Up to the mid-1990s, the standard rate of corporation tax in Ireland was 40%,<sup>5</sup> a marked contrast with the 10% rate. This ring-fencing of a favourable rate to one industrial sector breached the OECD (1998) guidelines on harmful tax competition, as well as several EU codes. As described in Killian (2006), the sustained pressure from Germany in particular made the status quo untenable. At the same time, it was accepted in Ireland that the low rate on manufacturing was key to retention of the country's stock of foreign direct investment.

The 10% rate was, in any case, due to expire in 2010, and with political pressure from overseas, it became apparent it could not be extended beyond that date. Ireland's response was to comply with the letter of the recommendation, and remove those rules that favoured manufacturing more than other forms of industry. However, rather than raising the rate on manufacturing to match the higher rate applying to other forms of

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<sup>4</sup> Equivalent to €429 million.

<sup>5</sup> Falling to 38% from April. Source: Saunders (2000, p130).

business, the mainstream corporation tax rate on trading profits was reduced to 12.5% on a phased basis from 1 January 2000, and this rate was applied to all companies resident in Ireland.

In terms of attracting foreign direct investment, the strategy seems to have been extremely successful. Gray et al (2009, p43) document Ireland's disproportionate share of the US investment made into the EU, observing that in 2009, the total stock of US investment in the country was \$166 billion, or almost 5% of all US foreign direct investment worldwide. Since its initiation, the 12.5% has acquired a totemic national significance, and over time the four main political parties have come around to supporting the rate<sup>6</sup>. It has become routine for the Minister for Finance to preface the annual national budget speech by a statement of continued commitment to maintaining this rate. Despite difficult negotiations with the Troika of EC, IMF and ECB, successive Irish governments have maintained an unswerving loyalty to the policy of low and predictable corporate taxes. A good example is the striking display of cross-party solidarity that greeted a motion proposed in the national parliament<sup>7</sup> in November 2010 by the current Minister for Finance, Michael Noonan, reaffirming Ireland's commitment to the 12.5% rate which, despite being proposed from outside the government benches, was supported by all of the parties. The government Minister for Enterprise, Trade and Innovation (Deputy Batt O'Keeffe), in supporting the motion, remarked:

Normally, I would not agree with an Opposition motion but on this occasion there is great value in this House sending a united message on the importance of keeping our corporation tax at 12.5%. (Oireachtas 2010)

His colleague Deputy Dara Dara Calleary, a more junior government Minister in the same department went on to say:

I affirm there will be no change to our corporation tax. It is an absolute red line in terms of any discussions that have taken place. Our corporate tax rate is critical to supporting our economic recovery and employment growth and is a cornerstone of our industrial policy and an integral part of our international brand. (Oireachtas 2010)

Despite, or perhaps because of this universal domestic support, in recent years, Ireland's tax regime has again attracted adverse international publicity. This has focused less on the low headline rate, and more on the complex tax-motivated structures put in place by companies such as Google, Apple and Microsoft which reduce their global tax bills to extremely low levels. One example is the use of a structure known as the *Double Irish*<sup>8</sup> whereby two Irish firms, one resident in Ireland and one in Bermuda are effectively regarded as a single Irish entity under US law, allowing profits to be routed through Ireland and sheltered in Bermuda. There is little or no benefit to the Irish exchequer from companies using the country as a conduit in this way. However, the nature of the scheme has brought scrutiny to the Irish tax system more generally, looking beyond the low rate of corporation tax to the rules on transfer pricing, the network of double tax treaties, and the establishment of shell companies in Dublin by some multinational

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<sup>6</sup> the only exception is the Socialist Party, which currently has one member in the 166-seat national parliament.

<sup>7</sup> See Oireachtas (2010) for details of the debate.

<sup>8</sup> Described in Killian (2011:32).

firms. The response of both government and opposition has consistently been to defend the sovereignty of Ireland's tax rate, and the transparency of the system.

However, although domestic political support for Ireland's corporation tax policies is overwhelming, and public support is strong, the way in which the Irish tax system has been used by some companies is incongruent with another key national commitment. In order to understand how Ireland's tax policy conflicts with its approach to overseas aid, it is important to understand the significance of the latter in the national psyche. Ireland scores very well on international measures of overseas development assistance. For example, the Centre for Global Development (CGDEV)'s annual Commitment to Development Index (CDI) ranks Ireland in the top ten in four of the past eleven years. This is driven by what CGDEV (2013) describe as 'its high quality foreign aid program, low emissions growth compared to GDP growth and its contributions to United Nations peacekeeping operations'.

In 2012, Ireland's Official Development Assistance amounted to €629 million, or 0.47% of GDP (Irish Aid, 2012). Despite the economic downturn, public support for overseas development aid remains high. A survey carried out in December 2012 found that 85% of the general public believed it was important to continue direct support to developing countries, and 88% of respondents were proud of Ireland's record in this regard (Dochas 2012). This pride in Ireland's aid record is also evident in the words of the relevant minister, Joe Costelloe, on launching a volunteering initiative in October 2012:

Ireland is renowned for our solidarity with those in the greatest need. I am confident that, through our new Volunteering Initiative, we will build on our reputation and maximise our contribution in the fight to end global poverty and hunger (Irish Aid 2013).

Irish assistance to developing countries is an important part of the national psyche.

Despite this commitment, there are examples showing how Ireland's tax rules have interacted in an unhelpful way with the development aims of the countries served by its overseas aid policy. Irish Aid's budget is targeted at nine priority countries, mostly in sub-Saharan Africa. These are Ethiopia, Lesotho, Malawi, Mozambique, Sierra Leone, Tanzania, Uganda, Vietnam and Zambia. Zambia's share of the overall budget was approximately €16 million in 2012, roughly half of which was spent on education projects, with the balance weighted towards HIV and Health, Governance and Social Infrastructure programmes. The work is carefully monitored, and has a very positive impact within Zambia, all of which is transparently reported by Irish Aid.

In February 2013, Action Aid produced a report focusing on the tax affairs of Associated British Foods and their Zambian Subsidiary (Lewis 2013). The report details how interest on a loan taken out by the Zambian company from a South African bank was channelled through a group company registered in Dublin. The loan was denominated in local Zambian currency, and repaid through a bank in Lusaka. However, the fact that the payments were routed through Dublin meant that withholding taxes of approximately 15% on the interest were avoided. Management and other fees were also routed through this Dublin company, again taking advantage of the absence of withholding taxes in the Ireland-Zambia double tax treaty. This action reduced the tax revenue collectible in Zambia not only by avoiding the payment of withholding taxes, but also by reducing the taxable profit in the Zambian Subsidiary. Since tax revenue is a far more sustainable source of income for a developing country than overseas aid, the

way in which the Irish company was used was at clear cross purposes to Ireland's overseas aid objectives.

More generally, aggressive tax competition on the part of Northern countries including Ireland puts pressure on developing countries to reduce their own headline rate of corporation tax in response, in an effort to win foreign direct investment and to reduce the motivation to set up complex, cross-border structures to divert taxable profit away from the main manufacturing base. As an example, Lewis (2013) reports that the already low rate of 15% applied to the profits of Zambia Sugar has been further reduced in 2012 to 10%.<sup>9</sup> Altshuler and Grubert (2005) note that this should not be seen as a simple, incremental response. 'The results illustrate the importance of including both company tax planning and the cooperation of home and host governments in an accurate depiction of any race to the bottom' (Altshuler and Grubert 2005, p32). The corporate tax rates are falling not simply because of a process of mutual undercutting on the part of developing countries, but because of a more complex set of interactions involving a range of jurisdictions as well as the actions of multinational firms.

Ireland is by no means unique in having tax policies that conflict with overseas aid targets. Weyzig (2013) comprehensively details the massive impact of way in which multinational firms use the Dutch Double Tax Treaty network to channel profits away from developing countries. The cost in terms of lost revenue to developing countries which can be directly attributable to the use of Dutch tax treaties is estimated to have amounted to €100 million in 2007. The study concludes that in the case of the Netherlands, the 'causes of policy incoherence are structural and political in nature, because the interests of developing countries inherently conflict with special interests of various large multinationals and Dutch service providers' (Weyzig 2013, p185).

### 3. ANTI-AVOIDANCE AND THE CREATION OF AN INDUSTRY

In addition to the well-documented tax reliefs aimed at attracting foreign direct investment, other, more obscure features of the Irish tax regime have been used to reduce the profits of both domestic and non-Irish firms. One interesting historical example was the use of so-called 'Section 84 loans' as a basis for an aircraft finance industry around Shannon in the 1970s. Section 84 referred to S.84 of the 1976 Corporation Tax Act, an anti-avoidance provision designed to prevent the owners of closely-controlled companies from using artificial structures to extract dividend income from their companies in the legal form of interest, thereby creating a corporation tax deduction that would not otherwise be warranted. The anti-avoidance rules applied to loans where the interest varied with the underlying profit of the company, and effectively re-designated those interest payments as dividends, thereby denying a corporation tax deduction to the paying firm.

In denying a corporate tax deduction to the payor of 'S.84 interest', the rules created an exemption from corporation tax for the receiver. If all Irish companies paid tax at the same rate, these two effects would wash out in a neutral way. However, this was not the case. As mentioned above, companies which held a licence to operate in the Shannon Free Zone were subject to tax at a rate of 0%, so long as they fulfilled the terms of their licence.<sup>10</sup> This created a simple arbitrage opportunity whereby banks operating

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<sup>9</sup> This is a 'farming' rate, far below the headline corporate tax rate in Zambia.

<sup>10</sup> mainly by contributing to the development of the airport and region, importing and exporting goods, and meeting minimum employment requirements.

in Ireland and subject to tax at the then rate of 50% could extend S.84 loans to Shannon companies, by ensuring that the interest rate on those loans varied in some small way with the profits of the Shannon firms. Interest paid on those loans was not deductible for corporate tax purposes, which made no material difference to a Shannon borrower whose rate of corporation tax was zero. In the hands of the bank, however, the interest was received as a dividend, which rendered it tax free. At the same time, the banks could borrow to finance the loan, and claim a full corporation tax deduction on the interest they paid. With the prevailing rate of tax being 50%, this essentially allowed banks to lend to Shannon companies at half the 'normal' rate, and still make the 'normal' rate of profit.

Like any arbitrage opportunity, this was soon pushed to its limits. First, it was quickly realised that the bigger the loans made, the bigger the profits, which led logically to the growth of an industry which depended on very large levels of borrowing: big ticket leasing. Since the goods bought and sold by Shannon companies had in many cases to be imported and exported through the airport, it was natural that this became a thriving aircraft finance industry. Secondly, the fact that the tax-based profit depended on the rate of interest applying meant that S.84 loans were commonly denominated in high-coupon currencies with correspondingly high interest rates, such as Italian Lira or Australian Dollars. An Italian Lira loan, for instance, with a base lending rate of 16% allowed for a potential tax-based 'super-profit' of 8% of the amount of the loan per year. With simple hedging of the currency risk through the medium of currency swaps, the S.84 structures could be effectively 'bolted on' to existing leases which were already in place, denominated, in the most part, in US Dollars. The addition of the 'Shannon route' to a pre-existing aircraft lease allowed the overall interest rate on the deal to be reduced dramatically, in many cases to negative levels. The overall spread on the deal was shared between the main financing companies, creating a massive competitive advantage for aircraft finance companies located in the Shannon Free Zone, and leading to the genesis of an industry there where none had previously existed.

These 'super-profits' were not, however, generated out of thin air. They were based on artificial structures in the form of S.84 loans which allowed the Irish lenders to reduce their Irish tax bills dramatically. Effectively, the profits were generated from the Irish taxpayer. Over the course of time, European banks also participated in S.84 lending by establishing Irish subsidiaries, and routing their lending through them.

It is difficult to quantify the cost to taxpayers of these arrangements. Houghton (2002) estimates the direct cost to Ireland of Shannon Relief in 1989/90 as IR£29 million, equivalent to almost €37 million, based on applying a differential rate of tax to the profits of companies holding a Shannon licence. Parliamentary records from May 1988 support this figure, and also show the direct cost of the exemption from tax of S.84 interest received as dividends in 1987 to be £64 million or just over €81 million (Oireachtas 1998). Beyond this lies the amount of tax sheltered in Irish banks by interest paid on loans used to generate tax-free S.84 'dividends'. Since the detail on these loans is not in the public domain, no accurate estimate can be made. However, given that very large-ticket aircraft were financed in currencies with high interest rates, and that currency swaps created pure arbitrage opportunities for the consortia of lenders involved, the impact was certainly significant.

It is apparent, when viewed in this light, that the original aim of the S.84 provisions – the prevention of tax avoidance which would have led to a reduced tax take for the country – was utterly subverted by the creation of complex structures around S.84 loans

for aircraft finance. A measure intended to make it easier for the state to tax profits by preventing tax avoidance at a domestic level actually had the effect of inhibiting Ireland's ability to tax the profits of lending banks, and reduced the overall tax take in the country. It also spurred the creation of a massively successful aircraft finance industry, based on an unquantifiable level of occluded support from the Irish taxpayer.

#### 4. CONCLUSION

The examples above show two very different kinds of policy incoherence. The first example of Ireland's tax competition and overseas aid is closer to the dominant theoretical frame on policy incoherence. The beneficiaries of Ireland's overseas development aid whose welfare is impacted are, as theorized, a diffuse group, insufficiently organized or focused on Ireland to seriously influence policy. This begs the question of *cui bono*; what group benefits from Irish tax policy? It is not necessary that this should be a cohesive and well-organised group which might be in a position to actively influence the direction of the policy. It is also possible, as discussed in Killian (2013) that the decades of successful tax competition in Ireland, widespread public and overwhelming all-party political support for the corporate tax regime might operate at an unconscious level; a given set of policies have dominance not because of any direct personal benefit to one set of actors, but because there is a pervasive hegemonic belief that this is the appropriate way to direct the economy, and that certain tenets of tax policy are not open to question or amendment.

The second example is in many ways more interesting. On the surface, it is a simple story of the exploitation of a tax loophole to achieve ends which were not anticipated by the writers of the legislation. The diametric opposition of the outcome to the intention, however, together with the way in which its impact extended to international tax jurisdictions and the sheer scale of the industry it created make it a striking example of how tax rules, unlike other areas of law, are particularly vulnerable to aggressive interpretation. This leads to a less-documented form of policy incoherence: the unchecked consequences of an effective change in the impact and meaning of legislation arising from the self-interested exploitation of rules on the part of taxpayers and tax advisors. In both cases we have self-interest operating directly or otherwise to create an economic benefit for a one party at the expense of another. In the first case, the policy incoherence is tolerated (consciously or otherwise) by the policymakers. In the second, it is actively created by taxpayers and their advisors, and enabled to grow by the inaction of policymakers. As noted by Bird (2013:9), 'In a very real sense, 'tax administration is tax policy' (Casanegra de Jantscher 1990, p179)'. The absence of action is in itself a policy decision, and may in this case have been influenced by the success of the burgeoning aircraft leasing industry in Shannon, and also by the growing hegemony of successful attraction of FDI in Ireland.

Outside of the tax sphere, Ireland has not been behind the curve in the area of policy coherence, especially in the area of overseas development. For instance, the Evaluation Services of the European Union three-C report noted in 2007 that

It is apparent that the Nordic+ Group – Denmark, Finland, Ireland, the Netherlands, Sweden and the United Kingdom – have been most active and score well above average in terms of well-defined policies and institutional measures taken. However, the steps taken by all governments and institutions in establishing operational PCD mechanisms have generally been pragmatic,

fitting in with established ways of doing things in each particular governmental context. (ESEU 2007, p27)

Regrettably, such pragmatism, and acceptance of the established ways of doing business may be at the root of both forms of tax policy incoherence highlighted above, supporting the notion that Ireland's successful record in securing foreign direct investment over the last three decades may have led to a form of tax policy capture which may inhibit innovation in corporate tax policies. The role of tax advisors and tax planners in the creation of an industry based on S.84 lending also suggests that in studies of tax policy incoherence, the reinterpretation of rules by the taxpayer and the professions should be considered as a very significant factor. The cost, particularly in the case of a tax policy that interferes with aid objectives, unfortunately goes far beyond the financial.

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# Conduit companies, beneficial ownership, and the test of substantive business activity in claims for relief under double tax treaties\*

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## **Abstract**

If interpreted in a strict legal sense, beneficial ownership rules in tax treaties would have no effect on conduit companies because companies at law own their property and income beneficially. Conversely, a company can never own anything in a substantive sense because economically a company is no more than a congeries of arrangements that represents the people behind it. Faced with these contradictory considerations, people have adopted surrogate tests that they attempt to employ in place of the treaty test of beneficial ownership. An example is that treaty benefits should be limited to companies that are both resident in the states that are parties to the treaty and that carry on substantive business activity. The test is inherently illogical. The origins of the substantive business activity test appear to lie in analogies drawn with straw company and base company cases. Because there is no necessary relationship between ownership and activity, the test of substantive business activity can never provide a coherent surrogate for the test of beneficial ownership. The article finishes with a Coda that summarises suggestions for reform to be made in work that is to follow.

## **1. INTRODUCTION AND CONTEXT**

### **1.1 Double Taxation**

Most countries tax income on the basis of both residence and source.<sup>1</sup> As a result, cross-border transactions risk being taxed twice, both in the source country and in the country of residence. This is known as double taxation. One response is for states that have

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\* This article builds on a theme in Saurabh Jain, *Effectiveness of the Beneficial Ownership Test in Conduit Company Cases* (IBFD Amsterdam, 2013). Some text is developed from material in Dr Jain's book, and several transaction diagrams originally appeared in the book. Translations from foreign judgments and statutes that are not available in English are by Saurabh Jain, with the assistance of Kevin Holmes, Nicole Schlegel, René Andersen, Sarah Binder and Stephan Gerschewski, whose help is very gratefully acknowledged, as is the permission of the International Bureau of Fiscal Documentation.

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<sup>1</sup> For example, the *Income Tax Act 2007* (New Zealand) provides that both the worldwide income of a New Zealand tax resident and New Zealand sourced income are subject to New Zealand tax laws.

trading or investment relationships to enter treaties, known as ‘double tax treaties’, whereby the states that are parties to the treaty each agree to restrict their substantive tax law to ensure that income is not taxed twice. Double tax treaties are also known as ‘double tax conventions’ or ‘agreements’.<sup>2</sup> Most double tax agreements hew broadly to the form of the Model Tax Convention on Income and on Capital<sup>3</sup> promulgated by the Organisation for Economic Cooperation and Development, known as the OECD Model Convention. This model, and most treaties, contain articles that address the taxation of dividends, interest and royalties, collectively known as ‘passive income’.<sup>4</sup>

Where passive income flows from a source in one treaty partner to a resident of another treaty partner double tax treaties usually partially or fully exempt the income from withholding tax imposed by the state of source. For example, subject to Articles 10(3) and 10(4), Article 10(2) of the Convention between New Zealand and the United States of America limits the tax that contracting states may levy on dividends paid by companies that are resident within their jurisdiction where the dividends are beneficially owned by residents of the other contracting state.<sup>5</sup> Understandably, the intention of the contracting states is that only their own residents will obtain treaty benefits. It is possible, however, for residents of a non-contracting state to obtain the benefits of a tax treaty by interposing a company in a contracting state, a company that subsequently forwards passive income to the residents of the non-contracting state. This scheme subverts the intention of the contracting states to confine benefits to their own residents. Companies interposed in this manner are sometimes called ‘conduit companies’. Conduit company cases usually turn on whether the company in question should be characterised as the beneficial owner of passive income that it receives, or as a conduit that merely forwards passive income to people who are not residents of one of the states that are parties to the treaty in question.

## 1.2 Conduit Companies, Beneficial Ownership and Corporate Personality

Conduit companies are able to obtain treaty benefits because of two factors. First, people establishing companies destined to serve as conduit companies contrive to ensure that the conduit qualifies as resident in the jurisdiction of a treaty partner pursuant to the residence rules of the partner in question. Ordinarily, this objective can be achieved by simply incorporating the company in the state in question. Take, for instance, the Mauritius Income Tax Act 1995. Section 73 of that Act provides that a company that is ‘resident’ in Mauritius means a company incorporated in Mauritius. Secondly, as far as companies are concerned, treaties operate on a formal, legalistic basis rather than on a substantive basis.<sup>6</sup>

<sup>2</sup> An example is the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-N.Z., July 23, 1982, 35 U.S.T. 1949 [hereinafter U.S.-N.Z. Convention] updated by protocols in 1983 and 2010.

<sup>3</sup> Organisation for Economic Co-operation and Development [hereinafter OECD] Committee on Fiscal Affairs *Model Tax Convention on Income and on Capital* (2010).

<sup>4</sup> For example, Art. 10, 11 and 12 of the U.S.-N.Z. Convention, *supra* note 2, address the taxation of dividends, interest and royalties respectively.

<sup>5</sup> U.S.-N.Z. Convention, *supra* note 2.

<sup>6</sup> See OECD COMMITTEE ON FISCAL AFFAIRS, *Commentary on Article 10 concerning the Taxation of Dividends*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 186, para. 1 (2010): ‘Under the laws of the OECD member countries, such joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders’.

By virtue of these factors, a company established in a country that is a party to a treaty takes advantage of the benefits that the treaty confers on residents even though in substance the company is acting on behalf of a resident of a third country.

The OECD Model Convention, and treaties that are drafted in accordance with it, attempt to frustrate this strategy by anti-avoidance rules that limit relevant treaty benefits to a resident who derives income as the ‘beneficial owner’<sup>7</sup> of that income. Treaties sometimes use terms such as ‘beneficially entitled’,<sup>8</sup> and ‘beneficially owned’<sup>9</sup> in order to achieve the same result. Thus, Articles 10(2), 11(2) and 12(2) of the OECD Model Convention respectively limit treaty benefits to a recipient who is the ‘beneficial owner’ of the dividends, interest, or royalties in question. As the following paragraphs of this article will argue, the problem is that, as a matter of linguistic logic, of company law, and of economic analysis, the expression ‘beneficial owner’ is not capable of fulfilling the anti-avoidance role that treaties assign to it.

From an economic perspective, conduit companies are not capable of owning income beneficially. The object of a company is to make profits for the benefit of its shareholders. It is merely a vehicle through which shareholders derive income. As Thuronyi has pointed out, in substance a company is no more capable of beneficially owning anything than it is capable of having a blood group.<sup>10</sup> Thus, a conduit company is not beneficially entitled to treaty benefits. Rather, it is the shareholders, residents of a non-contracting state, who substantially enjoy the benefit of passive income. It follows that in order to ensure that a resident of a contracting state who claims treaty benefits is entitled to treaty benefits in *substance*, double tax agreements should be interpreted in a *substantive economic sense*.

Nevertheless, the traditional and formal legal view is that companies have separate legal personality, and are therefore not only the legal but also the beneficial owners of their income. The observations of Justice Pitney in the case of *Eisner v Macomber*<sup>11</sup> reflect this view. Although *Eisner v Macomber* did not concern the issue of beneficial ownership of assets by companies, Justice Pitney observed that companies hold both legal and beneficial title to their assets:<sup>12</sup>

... [T]he interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it ... Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole.

The Commentary on the OECD Model Convention follows this approach. The Commentary explains that double tax agreements recognise the legal personality of

<sup>7</sup> E.g. Convention for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Indon.-Neth., art. 10(2), Jan. 29, 2002), 2287 U.N.T.S. 107.

<sup>8</sup> E.g. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Austl.-Can., art. 10(1), May 21, 1980, 1334 U.N.T.S. 235.

<sup>9</sup> E.g. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, Neth.-U.K., art. 10(1), Nov. 7, 1980, 1249 U.N.T.S. 209.

<sup>10</sup> Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 78 (1990).

<sup>11</sup> *Eisner v. Macomber*, 252 U.S. 189, 193 (1920).

<sup>12</sup> *Id.* at 206, emphasis added.

companies.<sup>13</sup> From the perspective of legal analysis and of the meaning of the word ‘ownership’, it follows that conduit companies are the beneficial owners of income that they derive and are entitled to treaty benefits.

### 1.3 Surrogate Tests of Beneficial Ownership

Courts appreciated that the beneficial ownership test was intended to frustrate conduit company arrangements. However, in the light of the traditional legalistic view of companies, and of the meaning of ‘ownership’, it seems that courts decided that they were unable to apply the beneficial ownership test literally. As a result, in order to prevent residents of non-contracting states from obtaining treaty benefits by means of the interposition of conduit companies, courts adopted two surrogate tests in place of the literal beneficial ownership test. These surrogate tests focus not on ownership of income by the company in question but on some other factual matter that is thought to be relevant. The tests can be categorised as ‘substantive business activity’ and ‘dominion’. ‘Dominion’ may be used to refer to such concepts as effective control of a company. These surrogate tests have not only been used by courts to decide conduit company cases, but have also been embodied in statute by some legislatures. This present article focuses on the first of the surrogate tests, the test of substantive business activity. The authors plan a second article on dominion.

### 1.4 Substantive Business Activity Test

The substantive business activity test examines whether a company carries out its own business activity. It is also referred to as the ‘substantive business operations’<sup>14</sup> test or ‘economic activity’<sup>15</sup> test. Originally, courts developed the substantive business activity test as a substance over form rule to determine whether the law should recognise domestic straw companies and foreign base companies as separate taxable entities. Since about 1987, the OECD, the German legislature, and the courts have extended the application of the substantive business activity test. The OECD included the substantive business activity test in the Commentary on its Model Convention on Income and Capital.<sup>16</sup> The German legislature has incorporated the substantive business activity test into s 50d(3) of the German Income Tax Act, which is a specific anti-avoidance rule aimed at preventing abuse of double tax treaties. Courts often use the substantive business activity test to decide conduit company cases.<sup>17</sup>

This article argues that substantive business activity should not be considered to be an indicator of beneficial ownership because there is a logical contradiction in using the presence of activity, substantive or not, to indicate ownership of any kind, let alone beneficial ownership. Even if one assumes that the fact that a company does not carry out a substantive business activity may indicate that a company lacks substance, and therefore cannot beneficially own income, the presence of business activity does not logically show that a company does beneficially own income sourced from another

<sup>13</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *Commentary on Article 1 concerning the Persons Covered by the Convention*, in MODEL TAX CONVENTION ON INCOME AND ON CAPITAL 45 (2010).

<sup>14</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *Double Taxation Conventions and the Use of Conduit Companies*, in INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES (ISSUES IN INTERNATIONAL TAXATION, No 1) 87, para. 42(ii) (1987) [hereinafter *Conduit Companies Report*].

<sup>15</sup> Einkommensteuergesetz [ESTG][Income Tax Act], Oct. 16, 1934, REICHSGESETZBLATT, Teil I [RGL. I] at 1005, § 50d(3) (Ger.).

<sup>16</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 6.

<sup>17</sup> See, e.g., *N. Indiana Pub. Serv. Co. v. Comm’r* 105 T.C. 341 (1995) (discussed in detail below).

country. That is, there is no necessary link between substantive business activity and beneficial ownership.<sup>18</sup> A company may carry out a substantive business activity, but have the additional purpose of forwarding income to a resident of a non-contracting state, and, therefore, not be the beneficial owner of the income.

This article also argues that by treating substantive business activity as a sufficient criterion for entitlement to treaty benefits, courts have sometimes recognised even tax avoidance as a substantive business activity. In summary, courts use substantive business activity to indicate beneficial ownership, but, when analysed carefully, OECD reports<sup>19</sup> and cases support the argument that there is no logical link between substantive business activity and beneficial ownership.

### 1.5 The Substantive Business Activity Test in the OECD Commentary and Reports

The Conduit Companies Report<sup>20</sup> and the OECD Commentary<sup>21</sup> set out certain provisions that negotiators may include in double tax treaties to frustrate conduit company schemes. These provisions will be referred to as ‘safeguard provisions’. The object of these safeguard provisions is to ensure that the entity that is claiming treaty benefits owns, controls, or is ultimately entitled to the income in question. That is, the focus of these provisions is on substantive economic ownership or beneficial ownership. One safeguard provision sets out this ‘look-through’<sup>22</sup> approach. According to this approach:

A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains, or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State.

This safeguard provision focuses on determining who has ownership or control of income, gains or profits. If the word ‘owned’ in this provision merely referred to legal ownership of the income in question, the provision would be illogical because the company unquestionably legally owns its income. In this provision, ‘owned’ must refer to substantive economic ownership or to beneficial ownership, reflecting the intention of treaty partners to limit treaty benefits to residents of contracting states.

Such safeguard provisions have a broad scope in the sense that they apply to a wide range of situations. Thus, there is a danger that the provisions will prevent a company claiming treaty benefits when it is genuinely entitled to them. The OECD Commentary and Report therefore recommend that the safeguard provisions should be applied with certain provisions that aim to ensure that treaty benefits are granted in genuine situations. The OECD Commentary and Report refer to these provisions as ‘bona fide provisions’. For the purposes of this article, the most important bona fide provision is the ‘activity provision’, which states that the safeguard provisions:

... shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from

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<sup>18</sup> See *supra* Part 1.6

<sup>19</sup> See *supra* Part 1.6.

<sup>20</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 14, at para. 42(ii).

<sup>21</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 13, at para. 13.

<sup>22</sup> *Id.* at para.13. See also *Conduit Companies Report*, *supra* note 14, at para. 23.

taxation claimed from the other Contracting State is with respect to income that is connected with such operations.

The effect of this provision is that the look through approach and other safeguard provisions that attempt to frustrate conduit company schemes will not apply where a company is engaged in substantive business operations in the territory of a treaty partner provided that the income in question is connected with those operations. For instance, where there is a treaty between states B and C, it would appear that a bank that is resident in state B may claim relief in respect of interest received from State C even if the bank's shareholders reside in state A and even if economically the bank's loan to a state C resident was funded by a deposit in the bank by a resident of state A.<sup>23</sup>

The natural corollary of this provision is that where a company carries out a substantive business activity the company is entitled to claim treaty benefits, whether or not the company is the substantive economic or beneficial owner of the income. Essentially, the substantive business activity criterion determines entitlement to treaty benefits and therefore overrides the substantive economic ownership requirement imported by the safeguard provisions. The OECD Model Convention and Commentary thus treat substantive business activity as in effect changing the incidence of ownership because they proceed on the basis that substantive business activity is somehow indicative of ownership of income; that is, that there is a logical link between substantive business activity and beneficial ownership.

## 1.6 Lack of Logic and the Substantive Business Activity Approach

Paragraph 119 of the 1998 report of the OECD on Harmful Tax Competition<sup>24</sup> also seems to proceed on the assumption that there is a logical link between substantive business activity and beneficial ownership. Paragraph 119 states that companies with no economic function incorporated in tax havens can be denied treaty benefits *because* these companies are not considered to be the beneficial owners of certain income formally attributed to them. This statement that companies without an 'economic function' or substantive business activity cannot be beneficial owners of income suggests that there is a causative relationship between substantive business activity and beneficial ownership. However, as argued in Part 1.4, it is illogical to use substantive business activity as an indicator of beneficial ownership. The reason is that the mere absence of business activity does not logically prevent a person from owning anything. But even if one assumes that the absence of business activity is a robust indicator of lack of beneficial ownership, the presence of business activity does not logically show that a company does own income beneficially.

The following example, elaborated from the example three paragraphs above, illustrates the argument. There are three jurisdictions, A, B, and C. C charges withholding tax on outward flowing interest. There is a standard form tax treaty between B and C, which eliminates tax on interest that flows between residents of those jurisdictions but there is no other relevant treaty. Investor is a resident of A. He owns Bank, a banking company that is incorporated in and that carries on business in B. In a separate transaction,

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<sup>23</sup> This hypothetical case is similar in relevant respects to *Ministre de l'Economie, des Finances et de l'Industrie v. Société Bank of Scotland*, 9 I.T.L.R. 683 (2006) considered in Part 6.9 of this article.

<sup>24</sup> OECD COMMITTEE ON FISCAL AFFAIRS, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE (1998).

Investor lends money at interest to Borrower, a resident of C. C charges withholding tax on the interest that Borrower pays to Investor.

In order to avoid the withholding tax charged by C, Investor rearranges his loan. Now, Investor lends to Bank, his company in B, which on-lends to Borrower in C. When Borrower pays interest to Bank, Borrower and Bank claim the benefit of the B-C treaty. Bank is not a mere conduit. It carries on a substantial banking business. But should this activity qualify Bank for exemption from tax imposed by C on the outward flowing interest? The answer should be ‘no’, because the substantive owner of the interest is Investor, a resident of A. But legally, as an independent legal personality, Bank owns the interest. Bank certainly carries on a substantive business and the interest appears to be connected with the operations of that business. Should this business qualify Bank to benefit under the B-C treaty in respect of interest that Investor owns in an economic sense? To grant this benefit to Bank would be contrary to the intent of the B-C treaty, because the economic beneficiary of the exemption is Investor, who is not a resident of one of the states that are parties to the treaty. This example illustrates that there is no logical link between beneficial ownership and substantive business activity.

On April 29, 2011, the Committee on Fiscal Affairs of the OECD published a discussion draft, ‘Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention’.<sup>25</sup> As its name suggests, the draft attempts to address difficulties with interpreting ‘beneficial owner’. It does so by putting forward possible amendments to some of the clauses in the Commentary to Articles 10, 11, and 12 of the OECD Model Tax Convention. The draft offers some insight into some of the problems of applying the Model to passive income, but as the present authors read it, the draft does not address the fundamental illogicality of treating activity as an indicium of ownership. The draft therefore sheds little light on the problems thrown up by the example discussed here. Part 7 of this article visits other aspects of the discussion draft.

The Swiss case of *A Holding ApS v Federal Tax Administration*<sup>26</sup> further illustrates that there is no logical link between beneficial ownership and substantive business activity.

## 2. BENEFICIAL OWNERSHIP, SUBSTANTIVE BUSINESS ACTIVITY AND ABUSE OF LAW BEFORE THE SWISS COURTS

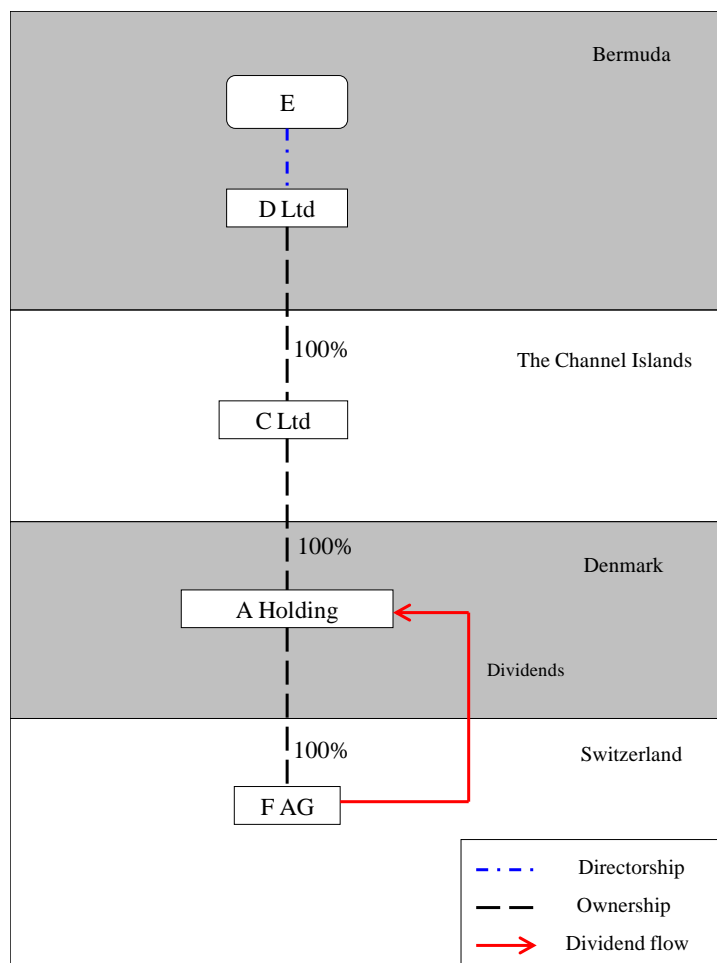
### 2.1 A Holding ApS v Federal Tax Administration: Facts

*A Holding ApS v Federal Tax Administration* involved a group of companies that were controlled by Mr E, a resident of Bermuda. Mr E was the director of D Ltd, a Bermudian corporation. D Ltd held all the shares in C Ltd, a subsidiary in the Channel Islands. C Ltd in turn wholly owned A Holding ApS (A Holding), a Danish holding company. A Holding was the taxpayer. It acquired the entire issued share capital of F AG, a Swiss company. A Holding did not have its own offices or staff in Denmark, and had no entries for assets, leasing or personnel expenditure in its books. F AG distributed dividends to A Holding, which were subjected to a 35 per cent withholding tax under Swiss tax law.

<sup>25</sup> OECD COMMITTEE ON FISCAL AFFAIRS, CLARIFICATION OF THE MEANING OF ‘BENEFICIAL OWNER’ IN THE OECD MODEL TAX CONVENTION: DISCUSSION DRAFT (2011).

<sup>26</sup> *A Holding ApS v. Fed. Tax Admin.*, 8 I.T.L.R. 536 (2005) (Federal Court, Switz.).



**Figure 1: A Holding ApS v Federal Tax Administration**

A Holding applied for a refund of the withholding tax under Article 26(2) of the Switzerland-Denmark double tax treaty of 23 November 1973.<sup>27</sup> The Swiss Federal Tax Administration and the Higher Tax Administration rejected A Holding's application.

Since the Switzerland-Denmark double tax treaty did not have a beneficial ownership provision<sup>28</sup> both courts applied the abuse of law doctrine.<sup>29</sup> They found that A Holding did not carry out a real economic activity. They therefore held that A Holding was interposed solely for the purpose of obtaining benefits of the treaty. The Higher Tax Administration, however, considered A Holding to be the beneficial owner of the dividends. The Swiss Federal Court confirmed the decision of the Higher Tax

<sup>27</sup> Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Fortune, Den.-Switz., art. 26(2), Nov. 23, 1973, 958 U.N.S.T. 27 [hereinafter Den.-Switz. Double Taxation Agreement]. It provides, '... the tax withheld (at the source) shall be reimbursed upon application, in so far as the levying thereof is restricted by the Agreement.'

<sup>28</sup> The beneficial ownership requirement was introduced to the Den.-Switz. Double Taxation Agreement, *id.*, in August 2009.

<sup>29</sup> See generally, Zoë Prebble & John Prebble, *Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law*, BULL. FOR INT'L TAX'N 151 (2008).

Administration and explained its reasons for applying the abuse of law doctrine and the substantive business activity test.

## 2.2 Abuse of Law and Beneficial Ownership

On appeal before the Swiss Federal Court, A Holding argued that in the absence of a beneficial ownership provision in the Switzerland-Denmark double tax treaty the abuse of law doctrine could not be read into the treaty. Secondly, A Holding argued that it was the beneficial owner of the dividend, which, it argued, excluded the application of the abuse of law doctrine.<sup>30</sup>

The Federal Court rejected A Holding's first argument, and held that the abuse of law doctrine could be read into the Switzerland-Denmark double tax treaty because the doctrine was consistent with the aim and purpose of the OECD Model Convention.

In relation to A Holding's second argument, the court accepted that A Holding was the beneficial owner of the dividend, but observed:<sup>31</sup>

Although the Higher Tax Administration has regarded [A Holding] as the beneficial owner of the dividends in accordance with art 10 [of the Switzerland-Denmark double tax treaty] one can assume an abuse. The assumptions of the court of lower instance were based on the fact that the distributed dividends are in principle attributable to [A Holding] for taxation in Denmark ... this does not answer the question whether the convention was invoked abusively ...

This observation suggests that the court distinguished between the beneficial ownership test and the domestic anti-abuse principle, because the court held that although A Holding was the beneficial owner of the dividend, this finding did not preclude the application of the anti-abuse principle. Furthermore, the court's analysis shows that the deciding principle in the case was the abuse of law doctrine, not beneficial ownership.

## 2.3 Abuse of Law and Substantive Business Activity

In the process of applying the abuse of law doctrine, the Swiss Federal Court based its decision on the criterion of whether there was a relevant business activity.

As discussed in Part 1.5 of this article, the commentary on Article 1 of the OECD Model Convention<sup>32</sup> recommends certain provisions that negotiators may include in double tax treaties in order to frustrate conduit company schemes. This article refers to these provisions as 'safeguard provisions'. Part 1.5 of this article discussed the 'look through' provision as an example of a safeguard provision. Since the Switzerland-Denmark double tax treaty had no beneficial ownership provision, the Swiss Federal Court in *A Holding* implemented the abuse of law doctrine using the look-through provision, which it referred to as the 'transparency provision',<sup>33</sup> to determine whether A Holding was entitled to treaty benefits. The transparency provision had not been incorporated into the treaty. In a broad-brush exercise of treaty interpretation the Federal Court simply took the transparency provision from the Commentary on the Model

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<sup>30</sup> *A Holding ApS*, 8 I.T.L.R. at 554.

<sup>31</sup> *Id.* at 559.

<sup>32</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 13.

<sup>33</sup> See *supra* Part 1.5 for quotation of the 'look-through' or 'transparency' provision.

Convention<sup>34</sup> and applied it to the case, almost as if it was a rule in its own right.<sup>35</sup> Applying the transparency provision, the court recognised that the corporate structure allowed Mr E to control A Ltd. Therefore, any refund would go directly to Mr E, a resident of a non-contracting state.<sup>36</sup>

As discussed in Part 1.5 of this article, the OECD Model Convention recommendations suggest that courts should apply safeguard provisions to limit the grant of treaty benefits to bona fide situations. In this case, the Court applied the ‘look through’ provision together with the substantive business activity approach. It observed:<sup>37</sup>

If the convention does not contain an explicit anti-abuse provision-[as] in the present case-an abuse can, based on the transparency provision, *only be assumed if* [A Holding] additionally does not carry out a real economic activity or an active business activity ... It follows that the objection of an abuse of a convention is unfounded if the company demonstrates that its main purpose, its management and the acquisition as well as the holding of participations and other assets from which the income in question arises is primarily based on valid economic grounds and not aimed at the obtaining of advantages of the applicable double tax convention (so called ‘bona-fide’-provision). The same applies if the company pursues effectively a commercial activity in its state of residence and the tax relief claimed in the other contracting state relates to income connected to this activity (so-called activity provision).

The court found that A Holding was not engaged in a business activity and therefore held that A Holding was not entitled to a withholding tax refund under the Switzerland-Denmark double tax treaty. The observation of the court that an abuse of law ‘can ... only be assumed if’ a company does not carry out a substantive business activity suggests that the court viewed the presence or absence of substantive business activity as the overriding factor in determining whether the abuse of law doctrine applied: that is, that there is a logical link between substantive business activity and an abuse of law.

## 2.4 Beneficial Ownership, Abuse of Law and Substantive Business Activity: Separate Tests?

In *A Holding*, the Swiss Federal Court considered the abuse of law doctrine to be separate from the beneficial ownership test, because, although the court considered A Holding to be the beneficial owner of the dividend, this conclusion did not preclude the application of the abuse of law doctrine. The Swiss Federal Court also considered the absence of substantive business activity to be an indicator of an abuse of law, because it stated that an abuse of law could only be assumed if there was a lack of business activity. A natural inference is that in the opinion of the court, beneficial ownership (which was found to be present) and substantive business activity (which was found to be absent) are two different tests. The decision of the Federal Court therefore suggests that there is no logical link between the criterion of substantive business activity and the criterion of beneficial ownership. On the other hand, it is difficult to reconcile the decision of the Swiss Federal Court that A Holding was a conduit company with the finding by the Higher Tax Administration that A Holding was the beneficial owner of

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<sup>34</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 13, at para. 13.

<sup>35</sup> *A Holding ApS*, 8 I.T.L.R. at 560.

<sup>36</sup> *Id.* at 560.

<sup>37</sup> *Id.* (emphasis added).

the dividend. It seems that the Higher Tax Administration applied the beneficial ownership test in a formal, legalistic manner. That is, the Higher Tax Administration took the view that a company was capable of being the beneficial owner of dividends, in contrast to the substantive economic view of ownership, that is that shareholders are the beneficial owners of dividends.

### **3.5 Should Business Activity be a Sufficient Criterion for Deciding Conduit Company Cases?**

As discussed in Part 2.3 of this article, in *A Holding* the court held that, in the absence of an explicit anti-abuse provision, abuse of a treaty ‘can ... only be assumed if [the company in question] ... does not carry out a real economic activity or an active business activity ...’<sup>38</sup> As further explained in Part 2.3, this formulation of the rule seems to have led the court and judges to think that the presence of ‘real economic activity or an active business activity’ is sufficient to dispel the contention that an intermediary is a mere conduit.

The business activity test may have led the court to the correct conclusion in this conduit company case. It is illogical, however, to base the decision in conduit company cases solely on the presence or absence of business activity. The fundamental error of logic is that the presence of business activity that is connected with the passive income that is in issue does not necessarily mean that an interposed company should not be classed as a conduit company. Nevertheless, courts have considered substantive business activity to be a sufficient criterion for deciding conduit company cases. (One might add that it is equally illogical to conclude that whether there is an abuse in fact depends on whether the relevant law—that is, the treaty—includes an anti-abuse provision). For this reason, it is important to examine the rationale behind decisions involving conduit companies.

## **3. WAS SUBSTANTIVE BUSINESS ACTIVITY ORIGINALLY A TEST FOR DECIDING CONDUIT COMPANY CASES?**

### **3.1 Introduction**

The argument in the following parts of this article has several strands. This paragraph and the next attempt to provide an introductory guide to that argument. Originally courts did not develop the substantive business activity test for conduit company cases. It was a substance over form test developed for cases involving foreign ‘base companies’. United States courts have also applied the substantive business activity test for determining tax issues in cases involving domestic ‘straw companies’. The paragraphs that follow cite examples of both these categories. Base company cases and straw company cases tend to turn on whether the companies in question are taxable entities separate from their shareholders. Courts have generally treated the presence or absence of business activity as a sufficient criterion to determine that issue.

Tax planning schemes involving base companies and straw companies resemble conduit company cases. The reason is that the corporate structures used by taxpayers to obtain a tax advantage are similar. As a result, the courts have transposed the application of the substantive business activity test from straw company and base company cases to conduit company cases. They have failed to recognise, however, that a conduit company case turns on a completely different issue. The issue in conduit

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<sup>38</sup> *Id.*

company cases is whether the shareholders of the conduit company are the substantive economic owners of the income of the company such that the company is entitled to the benefits of a tax treaty. On that basis, a conduit company case cannot be determined solely by the application of the substantive business activity test. Before explaining the distinction, it is helpful to describe straw companies and base companies.

### 3.2 Straw companies

‘Straw companies’ or ‘nominee companies’ are often used for non-tax reasons in business transactions involving real estate. In the present context, the word ‘straw’ in the expression ‘straw companies’ is a United States usage. A straw company merely holds legal title to a property. Its shareholders, or a third party, beneficially own the property.

Non-tax reasons for employing a straw company may include: avoidance of personal liability for loans obtained to acquire, improve or refinance property in real estate ventures;<sup>39</sup> protection from the claims of creditors of the beneficial owners of the property transferred to the company;<sup>40</sup> facilitation of management or conveyance of property owned by a group of investors;<sup>41</sup> and concealment of the identity of the beneficial owners of the property.<sup>42</sup>

Beneficial owners of property of straw companies anticipate that courts will ignore the existence of the company or will recognise the company’s agency status when attributing income, gains or losses. If courts treat a straw company as a separate taxable entity there may be adverse tax consequences. For example, property dealings between the company and its shareholders may result in taxable gains or losses of holding periods. Income and losses from the property may be attributed to the company during the time it holds the property, and shareholders may not be able to deduct those losses when they eventually receive income from the property.

In attempting to escape these adverse tax consequences, taxpayers argue that courts should disregard straw companies for tax purposes. They argue that a company’s activities are not sufficient to justify its treatment as a separate taxable entity.<sup>43</sup> That is, the courts apply a substantive business activity test to determine whether a straw company is a separate taxable entity.

### 3.3 Difference between Straw Company Cases and Conduit Company Cases

Both straw companies and conduit companies, as legal owners of income, forward the income to their shareholders, who are generally the beneficial owners. Prima facie the two situations are similar. However, they involve two very different issues.

In straw company cases, courts are aware that a straw company is not the beneficial owner of the company’s property. The issue is, rather, whether a company exists as a taxable entity separate from its shareholders, so that the company can be regarded as the *recipient* of the income for tax purposes. In contrast, in conduit company cases, courts are not concerned with whether the company incorporated in a foreign

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<sup>39</sup> E.g., *Bruce L. Schlosberg v. U.S.*, 81-1 U.S.T.C (CCH) P9272 (1981).

<sup>40</sup> E.g., *Moline Properties Inc. v. Comm’r*, 319 U.S. 436 (1943).

<sup>41</sup> E.g., *Roccaforte v. Comm’r*, 77 T.C. 263 (5th Cir. 1981).

<sup>42</sup> E.g., *Jones v. Comm’r*, 640 F.2d 745 (5th Cir. 1981).

<sup>43</sup> E.g., *Nat’l Carbide Corp. v. Comm’r* 336 U.S. 422 (1949). Taxpayers may accept the existence of the company as a separate tax entity, but argue that the straw company acts on their behalf as an agent.

jurisdiction is a separate taxable entity. The issue is whether the company owns passive income beneficially.

In conduit company cases, courts also decide effectively to ignore or to recognise the existence of an intermediary company for tax purposes. However, this decision is a consequence of the application of the beneficial ownership test. In straw company cases, on the other hand, this decision is a result of the application of the substantive business activity test.

The point is that the presence of a substantive business activity may be sufficient to treat a company as a taxable entity separate from its shareholder. However, as explained in Part 1.4, substantive business activity is not an indicator of beneficial ownership, and the presence of business activity does not necessarily mean that an intermediary is not acting as a mere conduit. Thus, this test may be appropriate for deciding straw company cases, but it is inappropriate for deciding conduit company cases.

### 3.4 Base Companies

Base companies are predominantly situated in a low tax or no-tax country, typically a tax haven. The main function of a base company is to shelter income that would otherwise directly accrue to taxpayers, for the purpose of reducing the tax that they have to pay in their home countries.<sup>44</sup> A supplementary function of a base company is to facilitate the improper use of tax treaties in a contracting state. A taxpayer who establishes a base company for this purpose may be a resident of the other contracting state,<sup>45</sup> or may be a resident of a third state. The key consideration for the taxpayer in setting up this scheme is the treaty network of the tax haven where the base company is located.

Most tax havens have either a very limited treaty network or none at all, though there are some treaties between havens and major industrial countries that allow domestic withholding tax to be reduced or eliminated, allowing the taxpayer to make a substantial saving.<sup>46</sup> Taxpayers avoid taxation of this income through the technique of 'secondary sheltering'.<sup>47</sup> Secondary sheltering involves changing the nature of income in order to benefit from exemptions contained in tax treaties or domestic rules in the taxpayer's country of residence. In order to change the nature of income, a taxpayer can use tactics such as re-ploughing income by loans to a shareholder or alienating a holding in a base company to realise capital gains that may be exempted or taxed at a lower rate.<sup>48</sup>

A base company is able to shelter income from taxation in the resident state because it exists as a legal entity separate from the taxpayer. Income that it collects does not fall under the normal worldwide taxation regime of the resident state. Thus, the taxpayer is

<sup>44</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *Double Taxation Conventions and the Use of Base Companies*, in INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES (ISSUES IN INTERNATIONAL TAXATION, NO 1), *supra* note 14, at 60, para. 1 [hereinafter *Base Companies Report*].

<sup>45</sup> See *Decision of the Bundesfinanzhof of 5 March 1986*, IR 2001/82, published in the Official Tax Gazette, Part II, 1986 at 496. See also Rijkele Betten, *Abuse of Law: Treaty Shopping through the Use of Base Companies*, E.T. 323 (1986).

<sup>46</sup> E.g., in the case of *N. Indiana Pub. Serv. Co. v Comm'r* 105 T.C. 341 (1995) see *infra* Part 4.1, the U.S.-Neth. double tax treaty extended to the Netherlands Antilles, which was then used as a tax haven.

<sup>47</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *Tax Havens: Measures to Prevent Abuse by Taxpayers*, in INTERNATIONAL TAX AVOIDANCE AND EVASION: FOUR RELATED STUDIES (ISSUES IN INTERNATIONAL TAXATION NO 1), *supra* note 14, at 20, para. 27.

<sup>48</sup> *Id.*

not liable to pay tax on income received by the base company.<sup>49</sup> Courts commonly use a substantive business activity test to decide whether to recognise a base company or to look through it to the ultimate owner of the income.

### 3.5 Why is Substantive Business Activity a Test for Base Company Cases?

Countries and courts have taken a number of measures to prevent tax avoidance that employs base companies. Some countries have enacted controlled foreign company legislation. Additionally, courts apply general anti-avoidance rules or judicial anti-avoidance doctrines like the abuse of law doctrine in civil law jurisdictions and the substance over form approach in common law jurisdictions.<sup>50</sup> In the United States in particular, the courts have applied judicial doctrines such as the business purpose test and the sham transaction doctrine to decide base company cases.<sup>51</sup>

As mentioned in Part 3.4, a base company is able to shelter income from tax in the resident state because the base company is an entity in its own right and is recognised as such in the resident country.<sup>52</sup> For this reason, taxpayers in base company cases are often taxed on a ‘piercing of the corporate veil’ approach.<sup>53</sup> Cases involving the application of this approach turn on whether a base company can be disregarded for tax purposes with the result that its activity, or income derived from its activity, may be attributed to the taxpayer.<sup>54</sup> Taxpayers often claim that the income cannot be attributed to them because it is derived from a substantive business activity. That is, courts apply the substantive business activity test to ascertain the nature of the activities of a base company.<sup>55</sup> If a court finds that a base company does nothing more than receive passive income that would have directly accrued to the taxpayer, then it may attribute income of a base company to the taxpayer.<sup>56</sup>

### 3.6 Difference between Base Company Cases and Conduit Company Cases

Base company cases involving parties from more than two jurisdictions may appear to be similar to conduit company cases in two respects. First, the structures of the corporate groups or chains that are involved are similar. Secondly, in both cases income accrues in an economic sense to the taxpayer in the resident country, so courts in both base company and conduit company cases effectively decide the question of whether income of an intermediary can be attributed to the taxpayer. Courts may apply the substantive business activity test to conduit company cases because of these similarities.<sup>57</sup>

Notwithstanding the apparent similarities between the two kinds of cases, it is inappropriate to treat base company and conduit company cases in the same manner because there are crucial differences.

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<sup>49</sup> *Base Companies Report*, *supra* note 44, at para. 10.

<sup>50</sup> See Prebble & Prebble, *supra* note 29.

<sup>51</sup> *Id.* at 164-166. See also DANIEL SANDLER, TAX TREATIES AND CONTROLLED FOREIGN COMPANY LEGISLATION: PUSHING THE BOUNDARIES 8 (1998).

<sup>52</sup> *Base Companies Report*, *supra* note 44, at para 10.

<sup>53</sup> See also *id.* at para. 24.

<sup>54</sup> See, e.g., *Hosp. Corp. of Am. v. Comm’r*, 81 T.C. 520 (1983), considered in Part 4.6 of this article.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*, though in *Hosp. Corp. of Am. v. Comm’r* the court found sufficient business activity to determine that the company in question was not merely an inactive base company.

<sup>57</sup> See, e.g., *N, Indiana*, 105 T.C. 341, discussed in Part 4.1 of this article.

A base company seeks to minimise tax in a taxpayer's country of residence. The base company, located in another jurisdiction, shelters income from taxation that would otherwise apply in the taxpayer's residence and in the process circumvents domestic tax law. For this reason, courts of the resident state decide a base company case in accordance with their domestic tax law. In contrast, a conduit company secures tax benefits in the country of source of passive income. A conduit company structure minimises tax by the improper use of double tax treaties that limit the source state's right to impose withholding tax. Because the conduit company secures benefits through a treaty, the courts of the source state decide conduit company cases in accordance with treaty law. To repeat the point in a slightly different way, base company structures shelter income from tax imposed on the basis of residence while conduit company structures reduce or eliminate tax imposed on the basis of source.

### 3.7 Purpose of Law as to Base Companies and Conduit Companies

Although courts may adopt a substance over form approach when deciding both kinds of cases, treaty law functions differently from domestic tax law. Treaty law applies the beneficial ownership test in order to ensure that an intermediary that is a resident of a contracting state by virtue of its incorporation enjoys passive income and does not pass the income on to residents of a third state. That is, the beneficial ownership test operates with the object and purpose of limiting treaty benefits to residents of contracting states. The application of the substantive business activity test to base company cases has a different purpose. That purpose is to determine whether (i) income that is derived by and retained by a base company should nevertheless be taxed to taxpayers who are resident in the state of residence on the basis that the income belongs in substance to those residents, or (ii) that it is not appropriate to tax the income to the residents to whom it belongs in substance because the base company has a good reason for deriving the income in its jurisdiction, namely that the income is derived in the course of a substantive business activity that is carried on in that jurisdiction.

On the other hand, although an intermediary that carries out a substantive business activity may be able to satisfy the requirements of the domestic tax law applicable to a base company case, such an intermediary may still act as a conduit, forwarding passive income to a resident of a third state.

Considerations of policy lead to the same conclusion. Take taxpayer A, a resident of country X, who owns a company, 'Baseco', that is resident in country Y. The policy question for country X is, should X tax the income of Baseco to its resident, A?

In essence, just because a base company case has been decided in favour of an intermediary on the basis of the company's business activity, it does not follow that a case that involves a conduit company that carries on a substantive business activity should also be decided in favour of the intermediary. That is, it is illogical to draw an analogy between base company cases and conduit company cases.

Nevertheless, courts have sometimes taken this quantum leap in conduit company cases. The case of *Northern Indiana Public Service Company v Commissioner of Internal Revenue* is a good example.<sup>58</sup>

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<sup>58</sup> *N. Indiana*, 105 T.C. 341; *N. Indiana Pub. Serv. Co. v. Comm'r*, 115 F.3d 506 (7th Cir. 1997).



#### 4. CONDUIT COMPANIES, BASE COMPANIES, AND STRAW COMPANIES BEFORE THE COURTS

##### 4.1 Northern Indiana Public Service Company v Commissioner of Internal Revenue: Facts

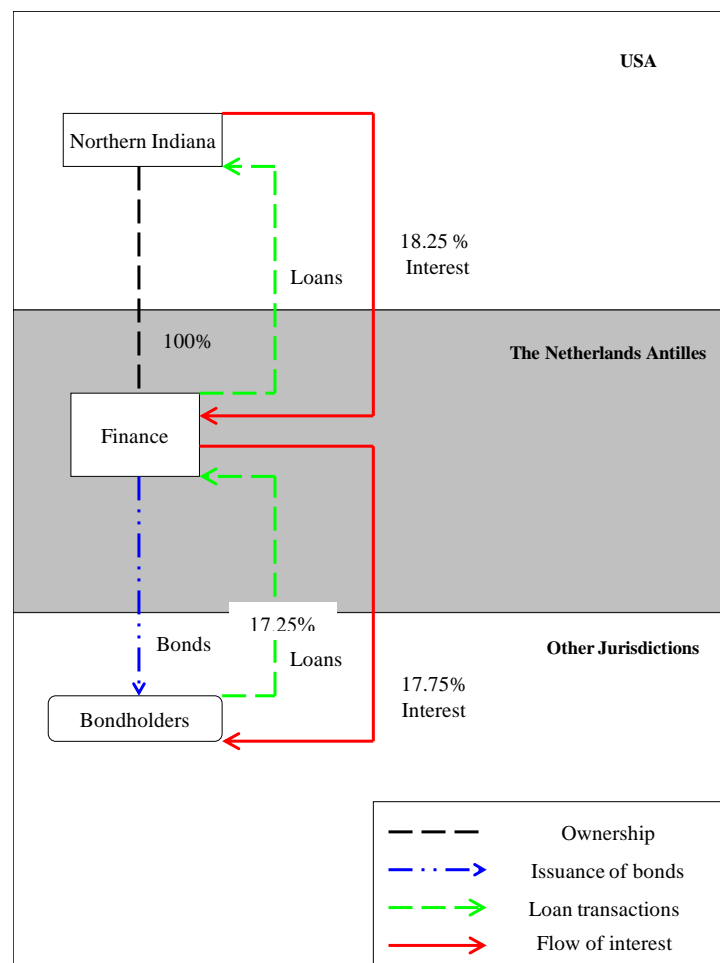
The *Northern Indiana* case involved Northern Indiana, a United States company that wished to raise funds on the Eurobond market. If Northern Indiana had borrowed funds directly from the Eurobond market it would have had to withhold United States withholding tax at the statutory rate on interest payments to the Eurobond holders, making Northern Indiana's offer less attractive in that market.

Article viii(1) of the United States-Netherlands double tax treaty of 29 April 1948,<sup>59</sup> which extended to the Netherlands Antilles, provided for a full withholding tax reduction on United States-sourced interest paid to companies in the Netherlands Antilles. Furthermore, the Netherlands Antilles charged no tax on such interest, irrespective of whether it flowed in to residents or out to non-residents.

In order to avoid paying United States withholding tax, Northern Indiana established a wholly owned Antillean subsidiary, which will be referred to as 'Finance'. The purpose of the structure was for Finance to borrow money from lenders in Europe, and to issue Eurobonds in return, rather than for Northern Indiana to do so. Instead, Finance on-lent the money borrowed from the bondholders to Northern Indiana. Finance lent money to Northern Indiana at an interest rate that was one per cent higher than that at which Finance borrowed from Eurobond holders. There were two consequences. First, Finance claimed the benefit of the US-Netherlands treaty described in the previous paragraph. Secondly, Finance earned a profit in the Antilles that it invested to produce more income. Eventually Northern Indiana repaid the principal amount with interest to Eurobond holders through Finance, and then liquidated Finance.

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<sup>59</sup> Supplementary Convention Modifying and Supplementing the Convention with Respect to Taxes on Income and Certain Other Taxes, U.S.-Neth., Dec. 30, 1965, 17 U.S.T. 896. [hereinafter U.S.-Neth. Supplementary Convention]. The relevant part of art. viii(1) provides: 'Interest on bonds, notes, ... paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State.'

**Figure 2: The Northern Indiana case**

Northern Indiana did not deduct withholding tax from interest payments to Finance. The Commissioner issued a notice of deficiency to Northern Indiana, declaring it liable to pay the tax that it did not withhold.

## 4.2 Arguments and Decision in the Northern Indiana Case

It was not disputed that Northern Indiana structured its transactions with Finance in order to obtain the full withholding tax reduction under the United States-Netherlands double tax treaty.<sup>60</sup> The Commissioner argued that Finance was a mere conduit in the borrowing and interest-paying process, so Finance should be ignored for tax purposes, and Northern Indiana should be viewed as having paid interest directly to the Eurobond holders.

The United States Tax Court observed that: ‘Normally, a choice to transact business in corporate form will be recognised for tax purposes so long as there is a business purpose or the corporation engages in business activity.’<sup>61</sup> Because Finance was involved in the business activity of borrowing and lending money at a profit, the court recognised it as

<sup>60</sup> *N. Indiana*, 115 F.3d 506.

<sup>61</sup> *N. Indiana*, 105 T.C. at 347.

the recipient of interest payments from Northern Indiana.<sup>62</sup> The court held that the interest payments were exempt from United States withholding tax. The Court of Appeals for the Seventh Circuit agreed with the Tax Court. Because the Tax Court based its decision on the business activity of Finance, the Tax Court effectively considered substantive business activity to be a sufficient criterion to determine whether Finance qualified for treaty benefits.

#### 4.3 Northern Indiana: an Illogical Analogy

The Tax Court considered substantive business activity to be a sufficient criterion because it drew an analogy with straw company and base company cases that were decided on the basis of the substantive business activity test. It seemed to have confused the facts of the *Northern Indiana* case for the following two reasons.

First, according to the Tax Court, Finance was created for a business purpose, namely ‘to borrow money in Europe and then lend money to [Northern Indiana] in order to comply with the requirements of prospective creditors’.<sup>63</sup> This role is similar to that of a straw company. However, the fact that Finance was created for a business purpose was irrelevant to what the court should have seen as the real issue, which was whether Finance was the beneficial owner of the interest payments. Finance was not the beneficial owner of the interest payments; rather the Eurobond holders were the beneficial owners of the interest payments. The reason is that *Northern Indiana* involved the application of a double tax treaty, not the application of United States domestic tax law. The court, therefore, should have analysed the facts in the light of the object and purpose of the double tax treaty. The treaty in question did not use the term ‘beneficial owner’. Rather, it exempted interest from tax that was ‘paid to a resident corporation of one of the contracting states’. As explained in Part 1.1 and 1.2 of this article, this provision should be interpreted substantively. Receipt by a mere conduit that contrives to be resident in a contracting state does not satisfy the policy of the treaty.

Secondly, as with a taxpayer in a base company scheme, Northern Indiana (the taxpayer) established a foreign subsidiary to avoid tax in the United States, the country of its residence. However, Northern Indiana was a source company; unlike the position in base company structures, Northern Indiana interposed Finance to obtain a reduction in United States withholding tax under the United States-Netherlands double tax treaty. Moreover, Eurobond holders, rather than Northern Indiana, benefited from the treaty-based elimination of United States withholding tax on interest payments. This result was obtained even though Finance was not related to Eurobond holders. That is, the *Northern Indiana* case was a conduit company case, not a base company case.

The last paragraph says that Eurobond holders benefited from treaty-based elimination of withholding tax. This statement does not ignore that Northern Indiana was the ultimate beneficiary, in that by exploiting the treaty it was able to borrow at a rate of interest that was cheaper than the rate that it would have suffered had the Eurobond holders received their interest subject to United States withholding tax. In that eventuality, the bondholders would have required the interest to have been grossed up to a rate that would have yielded a net return to the bondholders equivalent to the net return that they received via the scheme that Northern Indiana in fact adopted. In this

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<sup>62</sup> *Id.* at 348.

<sup>63</sup> *Id.* at 354.

economic sense Northern Indiana benefited from the elimination of withholding tax on interest that it paid to Finance. However, this is not the sense in which we must use 'benefit' in connection with tax treaty benefits in respect of passive income. The focus is on benefits that treaties bestow on recipients of passive income, not on concomitant economic benefits that payers of passive income may derive as a result. In the *Northern Indiana* case the treaty conferred benefits on Finance, as a resident of the Netherlands Antilles, a benefit that Finance passed on to the bondholders.

By drawing an analogy between conduit company cases and base and straw company cases, the court in *Northern Indiana* analysed the facts within the wrong frame of reference. This point is further illustrated by comparing the *Northern Indiana* case with two other cases referred to by the court, namely *Moline Properties Inc v Commissioner of Internal Revenue*,<sup>64</sup> a straw company case, and *Hospital Corporation of America v Commissioner of Internal Revenue*,<sup>65</sup> a base company case.

#### 4.4 Moline Properties Inc v Commissioner of Internal Revenue

In *Moline Properties*, Mr Thompson mortgaged his property to borrow money for an investment that proved unprofitable. Thompson's creditors advised him to incorporate Moline Properties Inc (Moline) to act as a security device for the property. He conveyed the property to Moline in return for all of its shares. Moline also assumed the outstanding mortgage. Thompson then transferred the shares as collateral to a trust controlled by his creditors.

Until Thompson repaid the original loans, Moline carried out a number of activities, including assuming Thompson's obligations to his original creditors, defending proceedings brought against Moline, and instituting a suit to remove prior restrictions on the property. After Thompson discharged the mortgage and gained control over Moline, Moline entered into several transactions involving the property. These transactions included mortgaging, leasing, and finally selling the property. Moline kept no books and maintained no bank account. Thompson received the proceeds from the sale, which he deposited into his bank account. Although initially Moline reported the gain on sales of the property in its income tax returns, Thompson filed a claim for a refund on Moline's behalf and reported the gain in his own tax return.

The issue before the United States Supreme Court was whether the gain from the sale of the property was attributable to Moline. In order to answer that question, the court considered whether Moline should be disregarded for tax purposes, which turned on whether Moline carried on a business activity. The court observed:<sup>66</sup>

The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

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<sup>64</sup> *Moline Properties Inc. v. Comm'r*, 319 U.S. 436 (1943).

<sup>65</sup> *Hosp. Corp. of Am. v. Comm'r*, 81 T.C. 520 (1983).

<sup>66</sup> *Moline Properties*, 319 U.S. at 438.

According to the court, Moline's activities were sufficient to recognise it as a taxable entity separate from Thompson, and the court attributed the gain on sales to Moline.

#### 4.5 Difference between Northern Indiana and Moline Properties

It is difficult to understand how the court logically relied on *Moline Properties* when applying the substantive business activity test in *Northern Indiana*. The court in *Moline Properties* was aware that Mr Thompson was the beneficial owner of the property and of the income from its sale. The issue was whether Moline received income as a taxable entity separate from Thompson. In that context, the presence of business activity was sufficient to determine that Moline existed as a separate taxable entity. In contrast, in *Northern Indiana*, it was clear that Finance received payments. The issue should have been whether Finance was the beneficial owner of interest payments and was therefore entitled to treaty benefits, or was acting as a mere conduit. Nevertheless, the conclusion of the Tax Court in *Northern Indiana* shows that it focused on the issue of whether Finance was the recipient of the interest payments not on whether it was the beneficial owner of those payments.<sup>67</sup> At the risk of labouring the point, the issue in *Moline Properties* was receipt. Receipt was not in issue in *Northern Indiana*, which concerned ownership, a different matter.

The court in *Northern Indiana* considered Article viii(1) the United States-Netherlands double tax treaty. Although the provision did not use the term 'beneficial owner',<sup>68</sup> the focal issue should have been whether Finance was the substantive economic owner of the interest payments. That is, Finance was the beneficial owner, to use the term in its ordinary sense. The result was that, although the context of the double tax treaty required the court to interpret the provision from a substantive economic perspective, the court in fact interpreted it from a formal legalistic perspective.

The Tax Court observed: '*Moline Properties, Inc. v. Commissioner* ... stands for the general proposition that a choice to do business in corporate form will result in taxing business profits at the corporate level.'<sup>69</sup> This observation shows that the court in *Northern Indiana* interpreted the treaty provision and considered the facts by applying the analytical framework that satisfied the domestic law requirements exemplified in *Moline Properties*. As a result, the court mistakenly drew an analogy with domestic straw company cases and concluded that tax should be levied at the corporate level rather than at shareholder level. In contrast, the relevant issue for treaty interpretation is not so much who receives the income but who owns it. In other words, is the recipient the owner of the income in the relevant, substantive sense?

#### 4.6 Hospital Corporation of America v Commissioner of Internal Revenue<sup>70</sup>

As mentioned in Part 4.3, the Tax Court in *Northern Indiana* also referred to *Hospital Corporation of America*, a base company case. In this case, Hospital Corporation of America (Hospital Corporation), entered into a management contract with King Faisal

<sup>67</sup> *N. Indiana*, 105 T.C. at 348.

<sup>68</sup> U.S.-Neth. Supplementary Convention, *supra* note 59. The relevant part of art VIII(1) provides: 'Interest on bonds, notes, ... paid to a resident or corporation of one of the Contracting States shall be exempt from tax by the other Contracting State.'

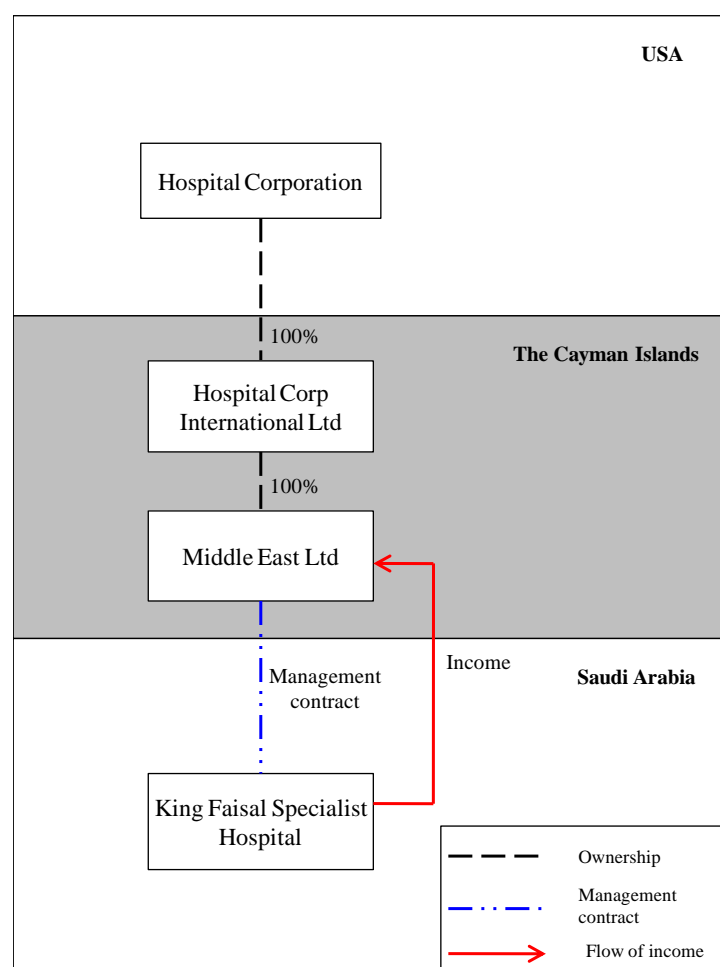
<sup>69</sup> *N. Indiana*, 105 T.C. at 351.

<sup>70</sup> *Hosp. Corp.*, 81 T.C. 520.

Specialist Hospital in Saudi Arabia. Hospital Corporation established the following corporate structure.

Hospital Corporation incorporated Hospital Corp International Ltd, a wholly owned subsidiary in the Cayman Islands. Hospital Corp International Ltd held all the shares in Hospital Corporation of the Middle East Ltd (Middle East Ltd), also incorporated in the Cayman Islands. Middle East Ltd and Hospital Corporation had the same officers and directors. Middle East Ltd did not have its own office. Rather, it shared an office with the law firm that prepared its incorporation documents. Hospital Corporation decided to administer the management contract through Middle East Ltd, which acted as a base company. That is, Middle East Ltd had the role of trapping income in a tax haven, the Cayman Islands.

**Figure 3: The Hospital Corporation of America case**



There were two issues before the court: first, whether Middle East Ltd was a sham corporation that should not be recognised for tax purposes; secondly, whether its

income was attributable to Hospital Corporation under section 482 of the Internal Revenue Code.<sup>71</sup>

The United States Tax Court found that Middle East Ltd ‘carried out some minimal amount of business activity’.<sup>72</sup> The court observed:<sup>73</sup>

[Middle East Ltd] possessed the ‘salient features of corporate organization.’ .... [Middle East Ltd] was properly organized under the Companies Law of the Cayman Islands. In 1973, [Middle East Ltd] issued stock, elected directors and officers, had regular and special meetings of directors, had meetings of shareholders, maintained bank accounts and invested funds, had at least one non-officer employee, paid some expenses, and, with substantial assistance from [Hospital Corporation], prepared in 1973 to perform and in subsequent years did perform the [King Faisal Specialist Hospital] management contract. All of these are indicative of business activity.

The court explained that the quantum of business activity needed for a company to be recognised as a separate taxable entity ‘may be rather minimal’.<sup>74</sup> Because Middle East Ltd carried out the above business activities, the court held that Middle East Ltd was not a sham corporation, and was a separate taxable entity for the purpose of federal income tax. However, the court held that 75 per cent of the net income of Middle East Ltd was allocable to Hospital Corporation because Hospital Corporation performed substantial services for Middle East Ltd without being paid.

#### 4.7 Difference between Northern Indiana and Hospital Corporation of America

It did not make sense for the court in *Northern Indiana* to rely on the reasoning of the court in *Hospital Corporation of America*. In *Hospital Corporation of America*, the court used the substantive business activity criterion to determine whether Middle East Ltd existed as a sham, or whether the company should be recognised as a separate entity for tax purposes. The activities that the court considered to be business activities seemed nothing more than those that necessarily preserve the existence of a company. The court was primarily concerned with the issue of the existence of Middle East Ltd as a separate taxable entity. For this reason, a minimal amount of activity was sufficient to satisfy the test that the court in *Hospital Corporation* had to apply. By contrast, in *Northern Indiana*, the issue should have been whether Finance received income substantively, that is, whether Finance owned the income in a substantive sense, or whether it functioned as a mere conduit.

Unlike *Northern Indiana*, *Hospital Corporation of America* did not concern a double tax treaty. It follows that the case was not decided in the context of the object and purpose of a treaty. The court in *Hospital Corporation of America* applied the sham transaction doctrine in the context of the United States domestic tax law, and found that the presence of business activity indicated sufficiently that Middle East Ltd was not a sham. On the other hand, *Northern Indiana* concerned the United States-Netherlands double tax treaty, and should have been decided in the context of the object and purpose

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<sup>71</sup> Section 482 of the Internal Revenue Code provides that the Secretary of the Treasury may allocate gross income, deductions and credits between or among two or more taxpayers owned or controlled by the same interests in order to prevent evasion of taxes or clearly reflect income of a controlled taxpayer.

<sup>72</sup> *Hosp. Corp*, 81 T.C. at 584.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.* at 579.

of that treaty. The fact that Finance carried out a business activity did not necessarily show that the arrangement was within the object and purpose of the treaty. Regardless of whether Finance was engaged in a substantive business activity, it was undisputed that Northern Indiana located Finance in the Netherlands Antilles in order to obtain treaty benefits. The application of the sham transaction doctrine cannot be equated with the application of the beneficial ownership test, even if the sham transaction doctrine deploys a substance over form approach. Nevertheless, in *Northern Indiana*, the Court of Appeal for the Seventh Circuit used the words ‘conduit’ and ‘sham’ interchangeably with reference to *Hospital Corporation of America*,<sup>75</sup> not, it seems, appreciating that, in *Hospital Corporation*, Middle East Ltd was not a conduit company at all. Indeed, Middle East Ltd’s purpose was the opposite, to act as a base company to trap income, not as a conduit through which income would flow. In short, the reasoning of the courts in *Northern Indiana* was mistaken.

A related point that emerges from this analysis is that the substantive business activity test logically works as a one-way test in conduit company cases. That is, the absence of business activity may establish that the interposition of an intermediary lacks substance; however, the fact that an interposed company has business activity does not necessarily show that the interposed company is not a conduit. This argument is further illustrated by the reasoning of the Bundesfinanzhof in decisions concerning section 50(3) of the German Income Tax Act,<sup>76</sup> as it stood before 19 December 2006.

Section 50d(3) deals with conduit company situations; however, as with the courts in *Northern Indiana*, the German legislature transposed the substantive business activity test from base company cases to conduit company cases. For this reason, the application of section 50d(3) resulted in inconsistent decisions in similar sets of facts before the provision was amended in December 2006.

## 5. THE SUBSTANTIVE BUSINESS ACTIVITY TEST IN GERMAN LEGISLATION AND LITIGATION

### 5.1 Section 50d(3) of the German Income Tax Act

Section 50d of the German Income Tax Act (abbreviated as ‘ESTG’) deals with cases where there has been a reduction in capital gains and withholding tax under German double tax agreements. Section 50d(3) of the ESTG is a countermeasure enacted to frustrate the abuse of treaties and abuse of the Parent-Subsidiary Directive of the Council of the European Communities.<sup>77</sup> The German legislature introduced section 50d(3) of the ESTG in 1994. Section 50d(3), before its amendment in December 2006,<sup>78</sup> read:<sup>79</sup>

A foreign company is not entitled to full or partial relief under sections 1 and 2 if and to the extent that persons with a holding in it would not be entitled to reimbursement or exemption had they received income directly, and if there is

<sup>75</sup> *N. Indiana*, 115 F.3d 506.

<sup>76</sup> Einkommensteuergesetz [ESTG] [Income Tax Act], Oct. 16, 1934, RGL. I at 1005, § 50d(3) (Ger.).

<sup>77</sup> Council Directive 90/435/EEC, on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 1990 O.J. (L 225).

<sup>78</sup> Einkommensteuergesetz [ESTG] [Income Tax Act], Oct. 16, 1934, BGBl I at 3366, as amended by Jahressteuergesetzes [Finance Law], Dec. 13, 2006, BGBl I at 2878, § 50d(3).

<sup>79</sup> Einkommensteuergesetz [ESTG] [Income Tax Act], Oct. 16, 1934, RGL. I at 1005, § 50d(3).



no economic or other relevant reason for interposing the foreign company and the foreign company does not have a business activity of its own.

Because the provision is not expressly restricted to dividends and withholding tax, it may be inferred that the provision also deals with conduit company situations in general.<sup>80</sup>

Section 50d(3) of the ESTG is a special anti-avoidance rule. It acts as a supplement to section 42 of the German General Tax Code<sup>81</sup> (abbreviated as 'AO'), which is the German general anti-avoidance rule. In wording section 50d(3), the legislature relied heavily on the principle developed in the context of section 42 of the AO by case law on the use of foreign base companies by German residents.<sup>82</sup> That is, as with the United States courts, the German legislature borrowed the substantive economic activity test from base company cases. As a result, the Bundesfinanzhof has drawn analogies with base company cases when interpreting and applying section 50d(3). A good example is the decision of the Bundesfinanzhof of 20 March 2002, which will be referred to as *G-group 2002*.<sup>83</sup>

Section 50d(3), as it stood before December 2006, was worded in the negative. That is, it set out conditions where a conduit company would not be entitled to a reduction of German withholding tax. In the decision of 31 May 2005, which will be referred to as *G-group 2005*,<sup>84</sup> the Bundesfinanzhof held that in order to deny tax relief the facts of a case should show that both economic or other valid reasons for the interposition of a corporation, and economic activity of the corporation itself, were absent at the same time. That is, when deciding whether to refuse treaty benefits, the court considered the conditions for refusal to be cumulative. To frame the test positively, in the view of the courts taxpayers qualify for benefits, and are not disqualified by section 50d(3), if they show that either there are economic or other valid reasons for the interposition of a company or that there is economic activity on the part of the company itself.

With deference appropriate to people who do not speak German, the authors venture that section 50d(3) appears to require the opposite, that is that taxpayers desiring to take advantage of relevant treaty benefits must satisfy both conditions. Be that as it may, in the context of conduit company cases even the existence of both conditions should not necessarily qualify companies for tax relief. Nevertheless, in the *G-group* cases, to be considered here, the Bundesfinanzhof treated the conditions as alternatives, either of which would allow tax relief under section 50d(3).<sup>85</sup> In effect, it regarded economic

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<sup>80</sup> See Rolf Fügen & Norbert Rieger, *German Anti-Avoidance Rules and Tax Planning of Non-Resident Taxpayers*, 54 BULL. INT'L BUREAU FISCAL DOCUMENTATION 434, 441 (2000). See also Wilhelm Haarmann & Christoph Knödler, *German Supreme Tax Court Limits the Scope of the German Anti-Treaty Shopping Rule and Redefines Substance Requirement for Foreign Companies*, 34 INTERTAX 260, 260 (2006).

<sup>81</sup> Abgabenordnung [AO] [The General Tax Code], Mar. 16, 1976, BUNDESGESETZBLATT, TEIL I [BGBL.] at 3366, as amended, § 42. According to § 42, the legal effects of provisions of the tax code may not be avoided by abusive behaviour on the part of the taxpayer. In the event of such behaviour, tax will be imposed as if the taxpayer had structured the situation using the appropriate form.

<sup>82</sup> See Fügen & Rieger, *supra* note 80, at 440.

<sup>83</sup> *Re a Corporation*, 5 I.T.L.R. 589 (2002) (BFH) (Ger.).

<sup>84</sup> Bundesfinanzhof [BFH] [Federal Tax Court] May 31, 2005, BUNDESSTEUERBLATT Teil II [BStBl. II] 14 (para. 27) (Ger.).

<sup>85</sup> *Id.* at para. 31(bb) (emphasis added).

activity as sufficient to qualify for double tax relief. In reaching this conclusion the Bundesfinanzhof relied on reasoning in base company cases.

The cases of *G-group 2002* and *G-group 2005* concerned the same group of companies. The two cases had similar facts and gave rise to the same considerations of policy. The same issues arose in each case. They both involved conduit companies, but they came to opposite conclusions. The reason was that in both cases the Bundesfinanzhof applied reasoning appropriate to base company cases.

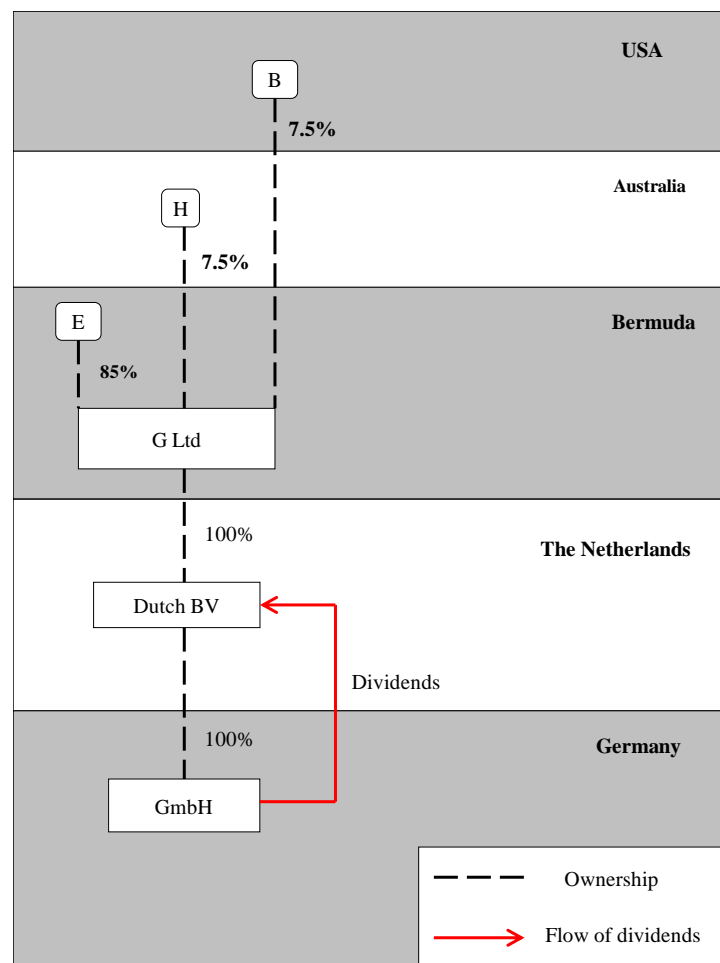
On the facts, base company reasoning made the cases appear to be distinguishable. In the first case the conduit company was virtually a shell. In the second case the conduit appeared to carry on business activity that might be described as ‘substantive’. The court distinguished the cases on the basis of this factor, which, on policy grounds, should have been irrelevant to the question of whether the taxpayer that derived the income in question and that claimed the relevant treaty benefits was in substance the beneficial owner of that income. Analysis of the facts of the cases illustrates these points.

## 5.2 The G-group 2002 Case: Facts and Decision

The *G-group 2002* case<sup>86</sup> concerned the G-group of companies, which were involved in the television sector. The corporate structure of the G-group started with Mr E, a resident of Bermuda, who held 85 per cent of the shares in G Ltd, a Bermudian corporation. Mr B, a resident of the United States, and Mr H, a resident of Australia, each held 7.5 per cent of the shares. G Ltd in turn owned Dutch BV, a company incorporated in the Netherlands. Dutch BV was the taxpayer. It used the business premises and other office equipment of another Dutch member of the G-group. Dutch BV held all the shares in GmbH, a German corporation.

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<sup>86</sup> *Re a Corporation*, 5 I.T.L.R. 589.

**Figure 4: G-group 2002**

GmbH paid dividends to Dutch BV, and deducted withholding tax from the payment. Dutch BV claimed a refund of German withholding tax under the German-Netherlands double tax treaty of 16 June 1959.<sup>87</sup> The German tax authority granted a partial reimbursement. This reimbursement corresponded to the participation of Mr H and Mr B in G Ltd in accordance with the respective German double tax treaties with Australia and the United States. The tax authority, however, denied any further reimbursement on the basis that Mr E, who was the majority shareholder, was a resident of Bermuda, which does not have a double tax treaty with Germany. The matter was heard before the Bundesfinanzhof.

The Bundesfinanzhof held that, because Dutch BV was ‘a *base company* without real economic function’,<sup>88</sup> the withholding tax relief could be refused under section 50d(3) of the ESTG,<sup>89</sup> as well as under section 42 of the AO. That is, although *G-group 2002* involved a conduit company scheme, the court referred to Dutch BV as a base company.

<sup>87</sup> Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Fortune and Various Other Taxes, and for the Regulation of Other Questions Relating to Taxation, Ger.-Neth., June 16, 1959, 593 U.N.T.S. 3 [hereinafter Ger.-Neth. Double Taxation Agreement].

<sup>88</sup> *Re a Corporation*, 5 I.T.L.R. at 599 (emphasis added).

<sup>89</sup> § 50d(3) of the ESTG was § 50d(1a) of the ESTG at the time of the decision.

### 5.3 G-group 2002: Another Analogy with Base Company Cases

The Bundesfinanzhof was of the opinion that section 50d(3) had similar requirements and, therefore, a similar aim, to the aim of section 42 of the AO.<sup>90</sup> Although the language of section 50d(3) clearly showed that the provision applied to conduit company cases, the court still drew an analogy with base company cases when interpreting the provision. It observed:<sup>91</sup>

According to the jurisprudence of the [Bundesfinanzhof] ... , intermediary base companies in the legal form of a corporation in a low tax regime country fulfil the elements of abuse if economic or otherwise acceptable reasons are missing. If income received in Germany is ‘passed through’ a foreign corporation, this is also true if the state of residence of the foreign corporation is not a low tax regime ... . The court accepts as a principle that tax law respects the civil law construction. But there must be an exception for such constructions [where they possess] only the aim of manipulation.

Although it was clear from the facts of the case that it involved the taxation of outward flowing income that had originated in Germany, the courts framed its reasons in terms of language appropriate to a case of income that flows inwards to Germany. The court used phrases such as ‘intermediary ... in the legal form of corporation’, ‘tax law respects the civil law construction’, and ‘exception for such constructions’. These words suggest that the court was preoccupied with the issue of when the separate entity of an intermediary could be ignored for tax purposes. As discussed in part 5.1, the German legislature’s reliance on base company cases when drafting section 50d(3) seems to be the reason for the court’s approach.

### 5.4 Is Business Activity a Conclusive Criterion for Deciding Conduit Company Cases?

In *G-group 2002*, the Bundesfinanzhof noted that Dutch BV had no employees, premises or office equipment. The court also considered the fact that the director of Dutch BV was serving as the director of other affiliated companies. It did not accept the contention of Dutch BV that its interposition was for reasons of organisation and co-ordination, establishment of customer-relationships, costs, local preferences, and the conception of the enterprise. The court observed:<sup>92</sup>

All these aspects make plain the background of the construction of the G-group, they make plain why and how European engagement of the group was concentrated within the Netherlands. But they cannot explain convincingly and justify why the foundation of [Dutch BV] as a letterbox corporation without economic or otherwise acceptable grounds was necessary.

The Bundesfinanzhof was not convinced that Dutch BV had developed its own economic activity.<sup>93</sup> It held that Dutch BV’s participation in GmbH, without any managing function, did not fulfil the requirement of economic activity under the provision.

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<sup>90</sup> *Re a Corporation*, 5 I.T.L.R. at 599.

<sup>91</sup> *Id.* at 600 (emphasis added).

<sup>92</sup> *Id.* at 601.

<sup>93</sup> *Id.*

Although the Bundesfinanzhof came to the correct conclusion, its logic does not make sense. The problem with the judgment is that the court analysed the facts in the light of reasoning in base company cases, rather than in the light of the context and purpose of the German-Netherlands double tax agreement.

Because of the analogy with base company cases, the Bundesfinanzhof's reasoning implied that the presence of economic activity was sufficient under section 50d(3) to allow treaty benefits. This reasoning is not explicit in *G-group 2002* because the court found that the activities of Dutch BV did not constitute 'economic activity' under section 50d(3).

This approach was evident, however, in *G-group 2005*, where the Bundesfinanzhof, dealing with very similar facts, found that the activities of the Dutch subsidiaries did constitute economic activity under section 50d(3).<sup>94</sup>

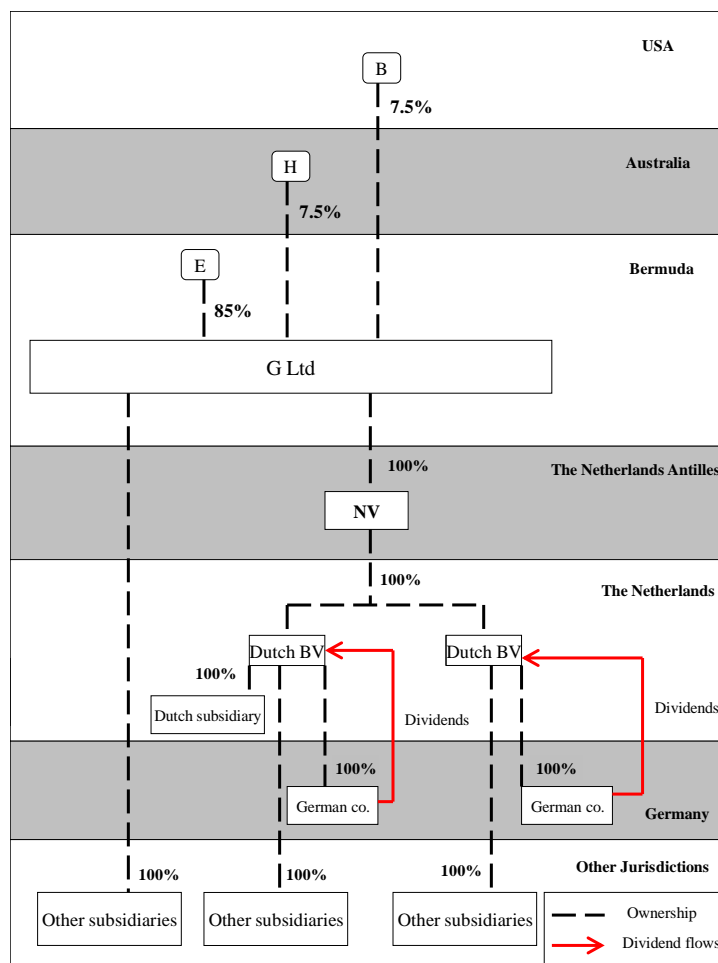
## 5.5 The G-group 2005 Case

*G-group 2005* concerned the same group of companies that were involved in *G-group 2002*. The corporate structure in *G-group 2005*, however, was slightly different. In *G-group 2005*, G Ltd wholly owned NV, a subsidiary incorporated in the Netherlands Antilles. In addition, G Ltd wholly owned other Dutch, European and non-European subsidiaries. NV, in turn, wholly owned two Dutch subsidiaries.

The main difference between *G-group 2002* and *G-group 2005* was that in *G-group 2005*, each Dutch subsidiary also held shares in other European and non-European corporations in addition to shares in a German company. As in *G-group 2002*, the Dutch subsidiaries in *G-group 2005* had no employees, business premises or equipment. Each subsidiary used the facilities of another affiliated Dutch company. The German companies paid dividends to the Dutch subsidiaries and deducted withholding tax.

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<sup>94</sup> BStBl. II 14 (para. 27) (Ger.).

**Figure 5: G-group 2005**

As with *G-group 2002*, the German tax authority in *G-group 2005* granted a reimbursement in proportion to the participation of Mr H and Mr B, who were residents of Australia and the United States respectively, but denied a reimbursement to Mr E, who was a Bermudian resident. The Bundesfinanzhof, however, allowed the refund under section 50d(3) of the ESTG.

The court found that the facts satisfied both of the requirements of section 50d(3). That is, there were economic and other relevant reasons for the interposition of the Dutch subsidiaries, and that the subsidiaries were involved in economic activities of their own.

## 5.6 Interpretation of Section 50d(3) in the Light of Base Company Cases

In a similar manner to the judicial reasoning in *G-group 2002*, the Bundesfinanzhof based its argument in *G-group 2005* on base company cases. When interpreting section 50d(3), the court observed:<sup>95</sup>

[Section 50d(3) of the ESTG] excludes the right of a foreign corporation to be tax exempted or to pay a lower tax ... according to a double taxation convention, if persons participating in that corporation would have no right to

<sup>95</sup> *Id.*

a reduction of tax had they received the dividends directly, and—first—there is no economic or otherwise valid reasons for the interposition of the corporation and—second—the corporation does not have an economic activity of its own. The latter two requirements are cumulative for the tax relief to fail.

It is clear that the court was of the opinion that the facts of a case must satisfy both conditions at the same time for the court to refuse a reduction in withholding tax under section 50d(3).

The Bundesfinanzhof noted that the Dutch subsidiaries were part of the G-group along with European and non-European affiliates engaged in active business.<sup>96</sup> Within the G-group, the Dutch subsidiary held the shares of some of these affiliates, including the German companies. The court regarded the mere holding of shares as economic activity.<sup>97</sup>

According to the Bundesfinanzhof, all affiliates confided the holding of shares within the group to independent corporations such as the Dutch subsidiaries. It found that this strategic outsourcing of the role of holding company was a long-term activity. It therefore concluded that in the present case the activity was not undertaken for the purpose of obtaining a withholding tax refund under the German-Netherlands double tax treaty. It noted that the Netherlands was the centre of the business of the European corporations of the G-group. Thus, the Dutch subsidiaries were not located in the Netherlands solely for the purpose of obtaining treaty benefits. The court, therefore, was of the opinion that the Dutch subsidiaries were entitled to treaty benefits by virtue of being residents of the Netherlands.<sup>98</sup>

On the basis of these findings the Bundesfinanzhof concluded:<sup>99</sup>

... [The Dutch subsidiaries] fulfilled their business purpose—holding of shares in foreign corporations—on their own account and autonomously. That is, the interposition of the Dutch subsidiaries had economic or other valid reasons. The absence of such reasons, however, is essential to deny a tax relief under [section 50d(3) of the ESTG]. Since [section 50d(3) of the ESTG] expressly refers to the (alternative) requirement of economic and other valid reasons, it is a special rule for abuse of law as compared to [section 42 of the AO], and may also be applied conclusively without reference to [section 42 of the AO].

## 5.7 Critique of the Reasoning of the Bundesfinanzhof

Two points emerge from this conclusion. First, the Bundesfinanzhof considered the *absence* of economic or other valid reasons to be essential when *refusing* tax relief under section 50d(3). However, when allowing treaty benefits under section 50d(3), the presence of economic or other valid reasons seem to be alternative requirements. That is, the requirement of economic or other valid reasons for interposition of the company in question and the requirement of economic activity seem to be alternatives when allowing treaty benefits. Thus, it could be inferred that if a company carried out an economic activity, the Bundesfinanzhof would allow the company to claim treaty

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<sup>96</sup> *Id.* at para. 30(aa).

<sup>97</sup> *Id.* at para. 32.

<sup>98</sup> *Id.* at para. 31(bb).

<sup>99</sup> *Id.* (emphasis added).

benefits. Effectively, the court considered economic activity to be a criterion sufficient to qualify the company in question for relief.

Secondly, the court equated the presence of ‘economic or other valid reasons’ with business purpose. In this respect, the reasoning of the Bundesfinanzhof resembles the reasoning of the United States Tax Court in the *Northern Indiana* case,<sup>100</sup> where the court drew an analogy with base company cases, and was of the opinion that a withholding tax reduction was available ‘so long as there is a business purpose or the corporation engages in business activity’.<sup>101</sup> It follows that, as with the court in *Northern Indiana*, the Bundesfinanzhof decided the case using an incorrect frame of reference.

Moreover, the holding of shares of affiliates seems to be a weak form of economic activity. Even if the holding of shares is an economic activity, there were no strong economic or other relevant reasons for interposing the Dutch subsidiaries. The considerations that the Bundesfinanzhof regarded as ‘economic and other relevant reasons’ for the interposition of Dutch holding companies seemed to be reasons for the organisation and co-ordination of the G-group.<sup>102</sup> In sharp contrast, the court in *G-group 2002* had rejected such reasons on the basis that they merely clarified the corporate structure and business engagements within the group.<sup>103</sup>

The analysis of *G-group 2002* and *G-group 2005* shows that when applying the substantive business activity test at least some courts draw analogies with base company cases. As a result, they decide conduit company cases erroneously, treating business activity as a sufficient criterion to qualify for tax relief.

It seems illogical to base a decision in a conduit company case on whether there is business activity. The discussion so far has shown that, logically, the criterion of business activity has merit as a one-way test in conduit company cases. For instance, judgments in *G-group 2002* and the *A Holding* case<sup>104</sup> show that the absence of business activity establishes that the interposition of a company lacks substance and, therefore, that the company can be categorised as a conduit. However, judgments in *G-group 2005* and the *Northern Indiana* case<sup>105</sup> fail to show convincingly that the presence of business activity necessarily indicates that the intermediary company does not act as a conduit.

## 6. WHAT CONSTITUTES SUBSTANTIVE BUSINESS ACTIVITY?

### 6.1 Introduction

Importing the test of substantive business activity from base company cases to conduit company cases is only a first step. Having taken that step, a court faces the dual questions of what amounts to ‘business’ activity and how much such activity must exist to earn the term ‘substantive’. The sections that follow examine cases that address these questions. Generally, courts conflate the two questions, asking simply, ‘was there substantive business activity’? Sometimes, there is not much going on, but the court

<sup>100</sup> *N. Indiana Pub. Serv. Co. v. Comm’r*, 105 T.C. 341 (1995)

<sup>101</sup> *Id.* at 347 (emphasis added).

<sup>102</sup> *Id.*

<sup>103</sup> *Re a Corporation*, 5 I.T.L.R. 589, 601 (2002) (BFH) (Ger.).

<sup>104</sup> *A Holding ApS v. Fed. Tax Admin.*, 8 I.T.L.R. 536 (2005) (Federal Court, Switz.).

<sup>105</sup> *N. Indiana*, 105 T.C. 341; *N. Indiana Pub. Serv. Co. v. Comm’r*, 115 F.3d 506, 510 (7th Cir. 1997).



will nevertheless find ‘substantive business activity’. Sometimes, the mere holding of shares and the management of passive income seems to constitute substantive business activity: a result that begs the question before the court, which is whether a holding of shares that undoubtedly exists amounts to a substantive business activity. On examination, such an activity (if holding shares can legitimately be called an ‘activity’ at all) often appears to have little purpose apart from obtaining treaty benefits.

The examination of what amounts to ‘substantive business activity’ that follows goes to the question of whether a company that claims to be carrying on a substantive business activity by virtue of holding shares should be dismissed as a mere conduit in two senses. First, assuming, contrary to the thesis of this article, that substantive business activity is an appropriate criterion, does such activity exist? Secondly assuming that the appropriate test for according treaty benefits is substantive ownership by a resident, it may be that whether there is substantive business activity may contribute to that test. Put another way, while the presence of substantive business activity should not, in the submission of this article, satisfy a court inquiring whether a company qualifies for treaty benefits as a resident, the absence of substantive business activity might be thought to disqualify the company.

## 6.2 Does Profit Spread Indicate Business Activity?

As discussed in Part 4.1, in the *Northern Indiana* case<sup>106</sup> there was a spread of one per cent between Finance’s inward and outward interest rates, which yielded a profit to Finance. Finance invested that profit to produce more income. According to the United States Court of Appeals for the Seventh Circuit, this transaction by Finance had economic substance. Thus, the court recognised Finance’s activity of borrowing and lending money as meaningful business activity.

The United States courts have used what is commonly known as a two-pronged test to determine whether a transaction has economic substance. First, a court must find that a taxpayer subjectively had a non-tax purpose for the transaction. That is, a transaction should be related to a useful non-tax business purpose that is plausible in the light of the taxpayer’s conduct and economic situation.<sup>107</sup> Secondly, there must be an objective possibility of a pre-tax profit. That is, the transaction must result in a meaningful and appreciable enhancement in the net economic position of a taxpayer (other than to reduce its tax).<sup>108</sup> This test has not been applied in a uniform manner.<sup>109</sup>

As discussed in Part 4.3, the United States Tax Court found that Finance was established for a business purpose. It seems that the United States Court of Appeals was referring to the second prong when it considered the profit spread in the *Northern Indiana* case. It observed:<sup>110</sup>

Here, a profit motive existed from the start. Each time an interest transaction occurred, Finance made money and [Northern Indiana] lost money. Moreover,

<sup>106</sup> *N. Indiana*, 115 F.3d 506.

<sup>107</sup> E.g., *James A. Shriver v. Comm’r*, 899 F.2d 724 (8th Cir. 1990).

<sup>108</sup> *Knetsch v. United States*, 364 U.S. 361 (1960).

<sup>109</sup> Courts have applied the two-pronged test disjunctively and subjectively. Some courts have not used the two-pronged test. These courts have viewed business purpose and economic substance as mere precise factors to determine the issue of whether the transaction had any practical economic effect rather than the creation of some tax losses. See *Transcapital Leasing Assocs 1990-II LP v. U.S.*, 97 A.F.T.R.2d 2006-1916 (2006).

<sup>110</sup> *N. Indiana*, 115 F.3d at 514 (emphasis added).

Finance reinvested the annual ... interest income it netted on the spread in order to generate additional interest income, and none of the profits from these reinvestments are related to [Northern Indiana].

### 6.3 Re-invoicing and Diverted Profits

Finance's activity of earning a profit on the inward and outward interest flows corresponds to a conventional re-invoicing transaction, which is generally regarded as tax avoidance. Re-invoicing involves back-to-back transactions that manipulate prices to inflate deductions. Re-invoicing is usually used for buying and selling transactions, typically for exporting or importing. It involves three parties: a corporation that owns a business, an intermediary that can be located either in a foreign low tax jurisdiction<sup>111</sup> or in the country of the business owner;<sup>112</sup> and customers. Although the intermediary is often an affiliate of the business owner, in some situations the business owner uses disguised ownership.

Re-invoicing is considered to be a tax avoidance practice. The reason is that it involves a deliberate manipulation of prices charged between related parties, often based in different jurisdictions, with a view to allocating part of the combined profits to the jurisdiction with the lowest effective tax rate. The *Northern Indiana* case is a special case of price manipulation in which the interest spread was the price charged by Finance. Thus, when the court recognised the activity of Finance as a business activity, it effectively recognised tax avoidance as a business activity. Moreover, since it was undisputed that the transaction was structured in order to obtain a tax benefit,<sup>113</sup> the court effectively justified one technique of tax avoidance, treaty abuse, with another, re-invoicing.

Further, although Finance invested its profits in unrelated investments and thereby earned additional income, the position remained unchanged because Finance was wholly owned by Northern Indiana. Finance was created for a limited purpose and was liquidated after that purpose was accomplished. Within a predetermined time the profits reverted to Northern Indiana.

Where a corporate structure diverts profit to a subsidiary for that profit to revert to the parent company, it is a misuse of language to say that the diverted profit is an indication of business activity. *Revenue Ruling 84-153*<sup>114</sup> illustrates the point. That Ruling involved facts similar to those of *Northern Indiana*, including the interposition of a profit-making Antilles subsidiary.

### 6.4 Revenue Ruling 84-153: Profit Spread is Not Relevant At All

*Revenue Ruling 84-153* involved a United States parent company that maintained two wholly owned subsidiaries: one in the Netherlands Antilles and the other in the United States. The United States parent arranged for the Antilles subsidiary to raise funds by issuing Eurobonds. The Antilles subsidiary then on-lent the proceeds to the United

<sup>111</sup> E.g., *HIE Holdings Inc. v. Comm'r*, T.C. Memo 2009-130.

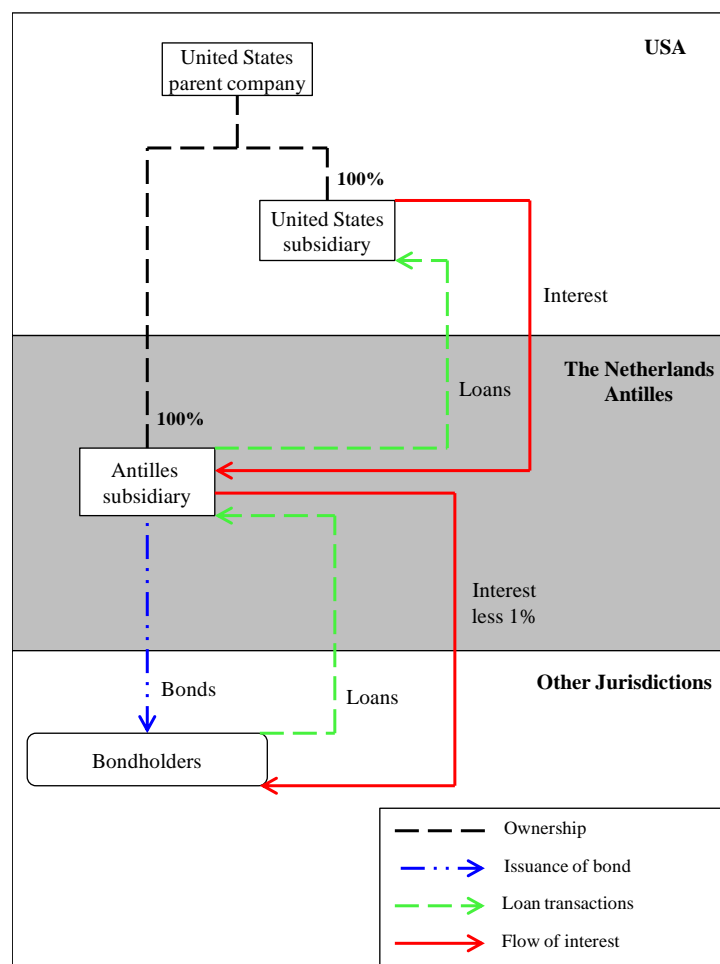
<sup>112</sup> E.g., *Cecil Bros Pty. Ltd. v. Fed. Comm'r of Taxation* (1964) 111 CLR 430 (Austl.); *Liggett Group Inc. v. Comm'r*, T.C. Memo 1990-18.

<sup>113</sup> *N. Indiana*, 115 F.3d at 511.

<sup>114</sup> Rev. Rul. 84-153, 1984-2 C.B. 383.

States subsidiary at an interest rate that was one per cent higher than the rate payable to the Eurobond holders. In the process, the Antilles subsidiary earned a profit.

**Figure 6: Revenue Ruling 84-153**



The Internal Revenue Service ruled that the interest payments from the United States subsidiary to the Antilles subsidiary were not exempted from United States withholding tax under Article viii(1) of the United States-Netherlands double tax treaty of 29 April 1948.<sup>115</sup> The Internal Revenue Service found that the use of the Antilles subsidiary in the transaction was motivated by tax considerations and lacked 'sufficient business or economic purpose to overcome the conduit nature of the transaction, even though it could be demonstrated that the transaction might serve some business or economic purpose'.<sup>116</sup> That is, although the Internal Revenue Service seemed to acknowledge the existence of the profit spread, it did not consider the spread to be relevant.

<sup>115</sup> Convention with Respect to Taxes on Income and Certain Other Taxes U.S.-Neth., Apr. 29, 1948, 32 U.N.T.S. 167 [hereinafter U.S.-Neth. Tax Convention]. The relevant part of Article viii(1) read: 'Interest (on bonds, securities, notes, debentures, or on any other form of indebtedness) ..., derived from sources within the United States by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment, shall be exempt from United States tax ...'.

<sup>116</sup> Rev. Rul. 84-153, 1984-2 C.B. 383, 383.

The Internal Revenue Service based its ruling on the object and purpose of double tax treaties. When interpreting Article viii(1) of the United States-Netherlands double tax treaty, the Internal Revenue Service observed:<sup>117</sup>

The words ‘derived ... by’ refer not merely to [the Antilles subsidiary’s] temporarily obtaining physical possession of the interest paid by [the United States subsidiary], but to [the Antilles subsidiary] obtaining complete dominion and control over such interest payments ... [F]or purposes of the interest exemption in Article viii(1) of the Convention, the interest payments by [the United States subsidiary] will be considered to be ‘derived ... by’ the foreign bondholders and not by [the Antilles subsidiary].

The Internal Revenue Service’s emphasis on the words ‘derived ... by’ shows that it focused on the issue of whether the Antilles subsidiary was the substantive economic owner of the interest payments. It interpreted Article viii(1) from a substantive economic point of view, which was consistent with the context in which double tax agreements function. This approach seems more appropriate than that adopted by the courts in *Northern Indiana*.

As discussed in Part 4.3, the court decided *Northern Indiana* by adopting reasoning from straw company and base company cases. It did not decide the case in accordance with the object and purpose of double tax treaties. If it is assumed that the court in *Northern Indiana* did consider the object and purpose of double tax treaties,<sup>118</sup> the court misinterpreted Article viii(1).<sup>119</sup>

The Court of Appeals for the Seventh Circuit observed that ‘Under the terms of the Treaty, interest on a note that is ‘derived from’ a United States corporation by a Netherlands corporation is exempt from United States taxation’.<sup>120</sup> Although the interest payments in question were made between 1982 and 1985, the United States Court of Appeals surprisingly chose to refer to Article viii(1) as it stood before its amendment in 1965.<sup>121</sup> The relevant part of Article VIII(1), before its amendment in 1965, read:

Interest ... derived from sources within the United States by a resident or corporation of the Netherlands not engaged in trade or business in the United States through a permanent establishment, shall be exempt from United States tax ...

The court’s interpretation of the provision shows that it emphasized the words ‘derived from’, rather than the words ‘derived ... by’ that the Internal Revenue Service emphasized in the *Revenue Ruling 84-153*. The court’s observation suggests that, rather than focusing on the issue of whether the substantive economic owner of the interest payments was resident in the Netherlands, the court was preoccupied with the fact that the taxpayer, *Northern Indiana*, was located in the United States. This observation reaffirms that the court analysed the facts erroneously.

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<sup>117</sup> *Id.* at 383.

<sup>118</sup> *N. Indiana*, 115 F.3d at 510.

<sup>119</sup> U.S.-Neth. Tax Convention, *supra* note 115, art. viii(1).

<sup>120</sup> *N. Indiana*, 115 F.3d.

<sup>121</sup> U.S.-Neth. Tax Convention, *supra* note 115, art. viii(1).

## 6.5 Reasons for the Existence of Interposed Company

On an analysis of the facts of the *Northern Indiana* case in the light of the object and purpose of double tax treaties, it is difficult to conclude that there were legitimate reasons for the existence of Finance, the company that was interposed between borrower and lender.

The United States Court of Appeals for the Seventh Circuit observed:<sup>122</sup>

The Commissioner has suggested that [Northern Indiana's] tax-avoidance motive in creating Finance might provide one possible basis for disregarding the interest transactions between [Northern Indiana] and Finance. The parties agree that Taxpayer formed Finance to access the Eurobond market because, in the early 1980s, prevailing market conditions made the overall cost of borrowing abroad less than the cost of borrowing domestically. It is also undisputed that [Northern Indiana] structured its transactions with Finance in order to obtain a tax benefit—specifically, to avoid the thirty-percent withholding tax. What is in dispute is the legal significance of [Northern Indiana's] tax-avoidance motive.

This passage rests on assumptions about tax avoidance that the court neither articulated nor, it seems, recognised.<sup>123</sup> These assumptions do not withstand scrutiny. The first such assumption is that avoiding tax may be justified if the taxpayer's motive is to achieve an increased return on the business or investment in question, if necessary by avoiding tax. But this motive surely drives any tax avoidance: why avoid tax if not to retain more of one's pre-tax income? If this justification were accepted it is hard to see any circumstances where the revenue could successfully challenge business or investment structures that are adopted for tax avoidance purposes.

The reasoning in the previous paragraph is stated broadly, being framed in terms of tax avoidance in general. The reasoning may be re-phrased to focus on the form of avoidance that is relevant for purposes of this article, namely avoidance by exploiting a tax treaty. Revisiting the passage quoted from the *Northern Indiana* case in the light of this sharper focus suggests that the passage assumes that an arrangement that frustrates the purpose of a double tax treaty by contriving to confer treaty benefits on residents of a third state is justified, or at least may be justified, if the reason for the arrangement is to reduce tax that would otherwise be suffered. To quote again the pertinent words, '[Northern Indiana] structured its transactions ... to avoid ... withholding tax'. The court rejected the Commissioner's challenge to the structure that Northern Indiana adopted to achieve that result. That is, the court seems to have accepted that a motive of avoiding withholding tax justifies tax avoidance. That reasoning is circular. It is tantamount to saying that avoiding tax is justified if one's motive is to suffer less tax. In short, the court's assumption does not withstand scrutiny.

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<sup>122</sup> *N. Indiana*, 115 F.3d at 510.

<sup>123</sup> The authors use 'tax avoidance' to label the middle category in the tri-partite framework of 'mitigation' (that is, reducing tax by legitimate means); 'avoidance', (meaning reducing tax by means that frustrate the intention of the law or, in civil law terms, by abuse of law); and 'evasion' (meaning reducing tax by concealment or other illegality). Prebble & Prebble, *supra* note 29, at 151, adds detail to this explanation. The 18<sup>th</sup> Congress of L'Académie Internationale de Droit Comparé, Washington DC, 2010, adopted the analytical framework of mitigation, avoidance, and evasion for its study of tax minimisation: A COMPARATIVE LOOK AT REGULATION OF CORPORATE TAX AVOIDANCE 1 (Karen B. Brown ed., 2012).

The first assumption, just discussed, focuses on the objective purpose of the arrangement in question, in the *Northern Indiana* case that purpose being also the purpose of the taxpayer. Consider now a second apparent assumption lying behind the passage from *Northern Indiana*. This second assumption focuses on the subjective motive of the taxpayer. The court seems to assume that an arrangement that avoids tax by contriving to obtain treaty benefits for residents of a third country may survive the Commissioner's challenge if the taxpayer's motives are unexceptionable. That is, even if from an objective perspective the arrangement itself has the purpose of avoiding tax the arrangement may be invulnerable to attack by the revenue if the taxpayer's subjective motives did not involve tax avoidance. An example might be where, for instance, it had not occurred to the taxpayer that the arrangement in question might reduce tax. In the opinion of the court, another example appears to be the case where the taxpayer wishes to take advantage of a source of funds available for borrowing that offers cheaper rates than domestic lenders, even though after tax that source would be more expensive because interest would be subject to withholding tax (absent the interposition of a treaty-shopping structure).

Such an argument should be untenable. Indeed, in general principle a court should disregard as self-serving a taxpayer's evidence that an arrangement that avoids tax by frustrating the objective of a treaty was driven by subjective reasons that do not involve tax avoidance. To summarise these points, even if one assumes that taxpayers' subjective motives are pure (at any rate, that the motives involve considerations other than tax avoidance), it does not follow that taxpayers' arrangements should escape challenge by the revenue. Taxpayers' motives may differ from the objective purpose of arrangements that they construct. It follows that it would be odd if taxpayers could defend avoidance arrangements by pleading that they had no intention to avoid tax, even if their pleas are true.

An analogy with Christian belief may help. Take the sixth Beatitude: 'Blessed are the pure in heart: for they shall see God'.<sup>124</sup> To Paul, this and other Biblical passages mean that '[A] man is justified by faith without the deeds of the law'.<sup>125</sup> In the *Northern Indiana* case the Court of Appeals for the Seventh Circuit appears to take a Pauline approach: if taxpayers' hearts are pure, justification is vouchsafed to them (at any rate they qualify for a reduction in tax). But the kind of faith that in Paul's view may be sufficient for justification hardly suffices in a fiscal context. When it is a question of minimising tax, taxpayers should be judged objectively, by their works, that is by the nature of the structures that they contrive.<sup>126</sup> As James wrote, 'You see that a man is justified by works and not by faith alone'.<sup>127</sup>

The Pauline approach of the Court of Appeals for the Seventh Circuit suggests that the court focused on *Northern Indiana*'s motive and analysed the company's borrowing structure in the light of that motive. The court emphasised that *Northern Indiana* wished to raise funds for its business and that the main reason for introducing Finance between lenders and borrower was to escape the higher rates of interest imposed in the United States. The court considered the motive of *Northern Indiana* to be related to business and therefore approved by law.<sup>128</sup> The court therefore concluded that the arrangement

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<sup>124</sup> *Matthew* 5:8.

<sup>125</sup> *Romans* 3:28.

<sup>126</sup> *C.f., Newton v. Fed. Comm'r of Taxation* [1958] AC 450 (P.C.) 465-466 (appeal taken from Austl.).

<sup>127</sup> *James* 2:24.

<sup>128</sup> *N. Indiana Pub. Serv. Co. v. Comm'r*, 115 F.3d 506, 512 (7th Cir. 1997).

withstood the Commissioner's challenge because it related to a business purpose. The court pointed out that the interposition of financing subsidiaries in the Netherlands Antilles was 'not ... an uncommon practice',<sup>129</sup> a practice acknowledged by the legislative history of the Federal Deficit Reduction Act 1984. This argument is tantamount to saying that an avoidance structure withstands challenge if everyone climbs on board, or, contrary to James, a pure heart is enough, do not be concerned with what the taxpayer actually does.

If this was indeed the view of the judges, it is odd. It is most unlikely that negotiators of double tax treaties or legislators in approving treaties would have in mind that residents of third states should obtain treaty benefits by the simple expedient of establishing a subsidiary in one of the states. In particular, how could a court sensibly attribute such a policy to the Senate of the United States? It is plausible to consider that United States legislators might take the view that the United States should not impose tax on foreigners who derive interest that flows to them from sources within the United States. Indeed, Congress later came to that conclusion.<sup>130</sup> But if legislators were of that opinion the obvious action was to repeal the tax, not to require foreign lenders who wished to take advantage of that policy to get their borrowers to establish financing subsidiaries in the Netherlands Antilles. Such a hypothetical policy would be incoherent.

Because the court in *Northern Indiana* analysed the facts from the wrong perspective, it focused on the fact that the taxpayer was a resident of the United States. In doing so the court seems to have overlooked that Eurobond holders who were residents of states other than the states that were parties to the treaty obtained tax advantages that the states parties had intended to go only to their own residents.

Even if it is assumed that Finance had a business activity, its activity seemed uncomplimentary to the business activity of Northern Indiana, a domestic utility company. Moreover, as discussed in Part 4.1, Finance was liquidated soon after Northern Indiana completed the payment of the principal amount plus interest to the Eurobond holders. These facts suggest that in the corporate structure Finance was merely a conduit for passing on interest to Eurobond holders.

## 6.6 Can Holding Shares Constitute a Business Activity?

As discussed previously,<sup>131</sup> in *G-group 2002*<sup>132</sup> the only business activity of Dutch BV was to hold shares of GmbH. Dutch BV had no personnel or business premises. The business director of Dutch BV served as the business director of other affiliated companies in the Netherlands. According to the Bundesfinanzhof, Dutch BV's activity did not constitute 'economic activity' under section 50d(3) of the EStG. It observed:<sup>133</sup>

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<sup>129</sup> *Id.* at 513.

<sup>130</sup> 'Section 127 of the Tax Reform Act of 1984 generally repealed the former 30 percent United States withholding tax on interest derived by non-resident aliens ... from certain debt obligations issued after July 18, 1984, by United States corporations, the United States government, and certain foreign corporations engaged in a substantial amount of business activity in the United States.' Roger E. Pront & Roger M. Zatieff, *Repeal of the United States Withholding Tax on Interest Paid to Foreigners*, 3 INT'L TAX & BUS. LAW. 191 (1986). More formally, the Tax Reform Act 1984 was the Deficit Reduction Act of 1984, Pub. L. No 98-368, 1, 98 Stat. 494 (1984).

<sup>131</sup> See *supra* Part 5.4.

<sup>132</sup> *Re a Corporation*, 5 I.T.L.R. 589, 602 (2002) (BFH) (Ger.).

<sup>133</sup> *Id.* at 601(emphasis added).

Additionally, there is no proof that the plaintiff has developed its own economic activity. To hold the participation [that is, the shares that the plaintiff company held] in the German G-GmbH without any *managing function* does not fulfil the requirements that can be expected for such an activity. The fact that the Parent-Subsidiary directive of the European Union ... in art 2 uses the wording ‘company of a Member State’ without any requirements of an activity does not change the statement. Even if it were conclusive that, according to the Directive, to hold one single participation in a corporation and, therefore, the existence of a pure holding corporation were sufficient ..., a simple letterbox-company with only formal existence like the plaintiff, however, would not correspond to the supranational requirements.

This observation implies that regardless of the number of companies in which an intermediary holds shares, this activity does not fulfil the requirement of ‘economic activity’ unless the intermediary carries out its own directorial functions. The Bundesfinanzhof followed this approach in *G-group 2005*.

As discussed in Part 5.5 in *G-group 2005* the affiliates out-sourced the passive shareholding activity to the Dutch subsidiaries. The Bundesfinanzhof considered holding of shares to be an economic activity. It emphasized two facts. First, the Dutch subsidiaries were holding shares of their own accord, and were functioning autonomously. Secondly, the Dutch subsidiaries held shares in other foreign companies in addition to shares in the German companies.<sup>134</sup>

Holding shares should not be regarded as an economic activity, even if the company manages its own operations. This argument applies even if the intermediary holds shares in more than one company. Holding shares is a weak form of business activity, and the fact that an intermediary that holds shares also has an active board of directors does not necessarily add any substance to the shareholding activity, at least not in the context of double tax treaties. Such an intermediary can still act as a conduit.

As explained in part 5.3 of this article, the reason why the Bundesfinanzhof in *G-group 2002* accorded importance to management functions seems to be that the court decided the case in the light of reasoning in base company cases. As explained in part 5.3, because the court drew an analogy with base company cases it was preoccupied with the issue of the recognition of an intermediary for tax purposes. As illustrated by *Hospital Corporation of America*,<sup>135</sup> courts in base company cases tend to consider the presence of an active board of directors to indicate that a corporation carries out substantive business activity and therefore can be recognised for tax purposes.<sup>136</sup> Nevertheless, *G-group 2002* and *G-group 2005* were conduit company cases, and, therefore, should have been decided in the light of the purpose of the Germany-Netherlands double tax treaty.<sup>137</sup> In *G-group 2005* ‘managing function’ acted as a misleading label that hid the conduit nature of the Dutch subsidiaries and allowed them to obtain treaty benefits improperly. By recognising ‘management function’ as ‘economic activity’ under section 50d(3), the Bundesfinanzhof effectively recognised the improper use of tax treaties as economic activity.

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<sup>134</sup> Bundesfinanzhof [BFH] [Federal Tax Court] May 31, 2005, BUNDESSTEUERBLATT Teil II [BStBl. II] 14 (para. 32) (Ger.).

<sup>135</sup> *Hosp. Corp of Am. v. Comm’r* 81 T.C. 520 (1983).

<sup>136</sup> At 584.

<sup>137</sup> Ger.-Neth. Double Taxation Agreement, *supra* note 87.



## 6.7 Reasons for the Existence of the Dutch Subsidiaries

It is difficult to find a reason for the existence of the Dutch subsidiaries in the G-group apart from obtaining the benefit of a full withholding tax reduction under the German-Netherlands double tax treaty. The diagram in Part 5.5 shows that apart from treaty benefits there seems to have been no point in the existence of the sub-holding companies inserted in the structure between G Ltd in Bermuda and the operating companies in Europe.

Double tax treaties between the Netherlands and the resident states of most of the affiliates provided for a full reduction of withholding tax on dividends. Thus, the location of the Dutch subsidiaries ensured that dividends flowed from affiliates in general and German companies in particular ultimately to Bermuda with a minimum tax impost.

As mentioned in Part 5.5, the Dutch subsidiaries within the G-group acted as conduits. The Dutch subsidiaries had no employees, business premises or equipment. Their business director served several other affiliates. They had no activity apart from holding the affiliates' shares.

As discussed in Part 5.6, the Bundesfinanzhof accorded importance to the activities of the other affiliated companies.<sup>138</sup> It noted that the Dutch subsidiaries formed part of a group of companies involved in the television sector. Within the group, they functioned as long-term shareholders in the other affiliated companies. The court regarded these facts as 'economic and other valid reasons' for the interposition of the Dutch subsidiaries.<sup>139</sup>

In contrast, when examining the activity of Dutch BV in *G-group 2002*, the Bundesfinanzhof observed:<sup>140</sup>

Finally, it is without any relevance in this connection that [Dutch BV's] sister-companies, also resident in the Netherlands, might fulfil the requirement of an economic activity and play an active functional part of the G group. Assuming that this is true, the only economic activity of the sister-corporations may not be attributed to [Dutch BV] in a way that [Dutch BV] could be treated as a managing holding corporation.

This observation illustrates that economic activity that is irrelevant to the income in question cannot be considered relevant when determining whether an intermediary is entitled to treaty benefits in respect of that income. In *G-group 2005*, the activity of the Dutch subsidiaries did not serve the economic interests of the affiliates. It follows that their activity did not add to the significance of Dutch subsidiaries in the G-group.

The German legislature amended section 50d(3) of the ESTG on 19 December 2006. In the amended section 50d(3) the German legislature specifically addressed the loopholes exploited by the taxpayer in *G-group 2005*. The provision, however, still uses business activity as a criterion, and fails to explain why an intermediary's

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<sup>138</sup> BStBl. II 14 (para. 32) (Ger.).

<sup>139</sup> *Id.* at para. 31(bb).

<sup>140</sup> *Re a Corporation*, 5 I.T.L.R. at 601.

economic activity should entitle the intermediary to be treated as a resident owner of the income.

## 6.8 The Amended Section 50d(3) of the ESTG

Section 50d(3), as it stands after its amendment on 19 December 2006, reads:<sup>141</sup>

<sup>1</sup>A foreign company is not entitled to a full or partial relief under sections 1 and 2 if and to the extent persons with a holding in it are not entitled to reimbursement or exemption, had they received income directly, and

1. There is no economic or other relevant reason to establish the foreign company or
2. The foreign company does not earn more than 10 per cent of its gross income from its own economic activity or
3. The foreign company does not participate in general commerce with business premises suitably equipped for business purposes.

<sup>2</sup>Only the circumstances of the foreign company shall be taken into account; organisational, economic and other significant features of companies that have close relations to the foreign company... shall not be considered. <sup>3</sup>The foreign company shall be regarded as having business operations of its own, as long as the foreign company earns its gross returns from the management of assets or a third party is in charge of their essential business operations.

<sup>4</sup>Sentences 1 to 3 shall not be applied if the main class of the shares of the foreign company is traded substantially and regularly on a recognised stock exchange or the foreign company is subjected to the rules and regulations of the Investment Tax Act.

By quantifying ‘economic activity’, and by clarifying its meaning, the provision may prevent companies without a business activity from obtaining the benefit of a withholding tax reduction under a double tax treaty. However, the provision fails to capture situations in which an interposed foreign company should be treated as a mere conduit despite being involved in a genuine business activity. This was the position in *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland*.<sup>142</sup> Although *Bank of Scotland* was a French case and did not concern section 50d(3) of the ESTG at all, it is relevant in the present context because it illustrates that section 50d(3) would have failed to function effectively if it had been applied to that case.

## 6.9 The Bank of Scotland Case

Pharmaceuticals Inc was a company resident in the United States. It held all the shares in Marion SA, a French company. In 1992 Pharmaceuticals Inc entered into a three-year usufruct contract with the Bank of Scotland, a company resident in the United Kingdom, under which the bank acquired dividend coupons attached to some shares of Marion SA. The Bank of Scotland acquired the usufruct in consideration for a single payment to Pharmaceuticals Inc. Under the contract, the bank was entitled to receive a

<sup>141</sup> Einkommensteuergesetz [ESTG] [Income Tax Act], Oct., 16, 1934 BGBl I at 3366, as amended by Jahressteuergesetzes [Finance Law], Dec., 13, 2006 BGBl I at 2878, § 50d(3). The numbering system adopted with superscript numbers 1 to 4 is the numbering system of the Einkommensteuergesetz. These superscript numbers appear in the beginning of sentences, not paragraphs.

<sup>142</sup> *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland*, 9 I.T.L.R. 683 (2006).

predetermined dividend from Marion SA in each of the three years of the usufruct. Pharmaceuticals Inc guaranteed the payment of dividends.

By French law, dividends that Marion SA paid to foreign recipients were subject to a 25 per cent withholding tax. Article 9(6)<sup>143</sup> of the France-United Kingdom double tax treaty of 22 May 1968 reduced French withholding tax to 15 per cent on dividends distributed to a company resident in the United Kingdom. The France-United States double tax treaty of 28 July 1967 contained a similar provision. But Article 9(7)<sup>144</sup> of the France-United Kingdom treaty also provided for a refund of the *avoir fiscal* that France imposed after the deduction of withholding tax.

Pharmaceuticals Inc designed its usufruct arrangement with the Bank of Scotland in order to obtain the benefit of the provisions of the France-United Kingdom double tax treaty. The arrangement would have allowed Pharmaceuticals Inc to obtain *both* a withholding tax reduction of 10 per cent (from 25 per cent to 15 per cent) and a refund of the *avoir fiscal*. Further, by the end of the three years of the usufruct, the Bank of Scotland would have received both its three years of dividends and a refund of the *avoir fiscal*. The aggregate of dividends and *avoir fiscal* would have exceeded the price that the Bank of Scotland paid to Pharmaceuticals Inc for the assignment of the right to dividends from Marion SA at the inception of the scheme. (No doubt the excess represented the bank's share of French tax that Pharmaceuticals Inc had hoped to save by means of the scheme.)

If Pharmaceuticals Inc had received dividends directly from Marion SA it would have paid 15 per cent French withholding tax under the France-United States double tax treaty but would not have qualified for a refund of the *avoir fiscal*.<sup>145</sup>

In 1993, Marion SA distributed dividends to the bank after deducting 25 per cent French withholding tax. The bank applied to the French tax administration for a partial refund of the withholding tax and a reimbursement of the *avoir fiscal* tax credit under France-United Kingdom double tax treaty.

### Figure 7: The Bank of Scotland case

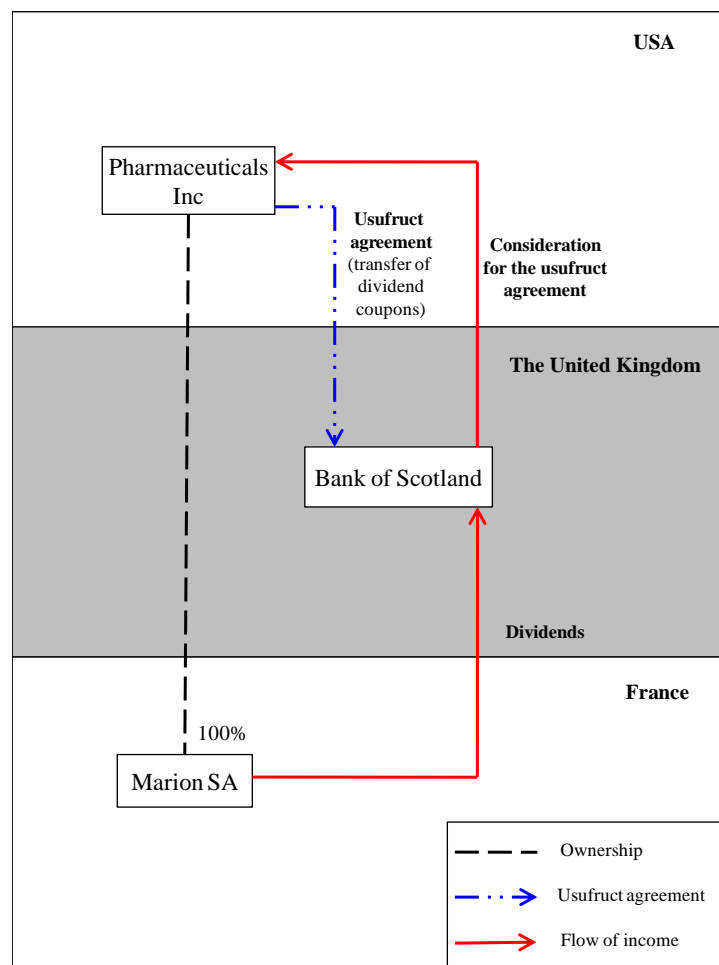
<sup>143</sup> Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Fr.-U.K., art. 9(6), May 22, 1968, 725 U.N.T.S. 3 [hereinafter Fr.-U.K. Convention]. It provided: 'Dividends paid by a company which is a resident of France to a resident of the United Kingdom may be taxed in the United Kingdom. Such dividends may also be taxed in France but where such dividends are beneficially owned by a resident of the United Kingdom the tax so charged shall not exceed:

(a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which controls the company paying those dividends;

(b) in all other cases 15 per cent of the gross amount of the dividend'.

<sup>144</sup> *Id.* at art. 9(7). The relevant part of art. 9(7) provided 'A resident of the United Kingdom who receives from a company which is a resident of France dividends which, if received by a resident of France, would entitle such resident to a fiscal credit (*avoir fiscal*), shall be entitled to a payment from the French Treasury equal to such credit (*avoir fiscal*) subject to the deduction of the tax provided for in sub-paragraph (b) of paragraph (6) of this Article.'

<sup>145</sup> *Id.* at art. 10(2)(b).



The French tax administration denied the request on the grounds that the Bank of Scotland was not the beneficial owner of the dividends. The tax administration characterised the transaction as a loan made by the bank to Pharmaceuticals Inc, which was repaid by the dividends from Marion SA.

The Supreme Administrative Court ruled in favour of the French tax administration. The court reasoned that the France-United Kingdom double tax treaty<sup>146</sup> entitled only the beneficial owner of dividends to both a refund of withholding tax and a reimbursement of the *avoir fiscal*. After analysing the contractual arrangements that comprised the usufruct, the court was of the opinion that Pharmaceuticals Inc was the beneficial owner of the dividends. Further, the price that the Bank of Scotland paid to Pharmaceuticals in consideration for the three-year dividend stream from Marion SA was in effect a loan, with the dividend stream repaying both interest and principal. That is, Pharmaceuticals Inc had delegated the repayment of the loan to Marion SA.<sup>147</sup> The court found that the sole purpose of the agreement was to obtain the benefit of *avoir*

<sup>146</sup>*Id.*

<sup>147</sup> *Ministre de l'Economie, des Finances et de l'Industrie v Société Bank of Scotland*, 9 I.T.L.R. 683, 703 (2006).

*fiscal* tax credit available under the France-United Kingdom tax treaty,<sup>148</sup> which was not available under the corresponding treaty between France and the United States.<sup>149</sup>

The outcome has a certain irony. The Supreme Administrative Court refused treaty benefits to the Bank of Scotland because it considered that the bank was not the beneficial owner of the dividends. That is, the court denied to the bank both (a) the reduced treaty rate on dividends and (b) a refund of the *avoir fiscal*. Had the parties not put the scheme into effect, and had Marion SA simply paid dividends to its shareholder, Pharmaceuticals Inc, the dividends would have qualified for the France-United States treaty rate, which, as mentioned, was 15 per cent, the same rate as under the France-United Kingdom treaty. By trying both to have its cake (a reduced treaty rate on dividends) and to eat it (a refund of the *avoir fiscal*) the bank lost both benefits. The case is an example of a tax planning own goal.

A theoretical argument might have partially saved the day for the Bank of Scotland. As mentioned, the court denied the 15 per cent France-United Kingdom treaty rate to the bank because the bank was not the beneficial owner of the dividends. But the beneficial owner was in the wings, namely Pharmaceuticals Inc, of the United States. It follows that in principle the dividends qualified to be taxed at 15 per cent by virtue of the France-United States treaty. The Bank of Scotland does not seem to have advanced this argument before the Supreme Administrative Court. No doubt the argument would have failed, if only because France delivers relevant treaty benefits not by reducing initial withholding tax but by refunding the taxpayer who has suffered the withholding in question. In the *Bank of Scotland* case that taxpayer was the bank, not Pharmaceuticals Inc.

#### **6.10 Would The German Section 50d(3) Have Worked in the Facts and Circumstances of The Bank Of Scotland Case?**

If the Bank of Scotland (or a taxpayer in a corresponding position) were to employ the scheme in the *Bank of Scotland* case to obtain benefits under a German tax treaty, it is possible that the bank, as a foreign company, would be allowed a withholding tax reduction by virtue of the business activity test under section 50d(3) ESTG. On the assumption that the Bank of Scotland's structure and business remained as it was at the time of the Pharmaceuticals Inc-Marion SA scheme, it would seem that the bank would satisfy the conditions of that provision. The Bank of Scotland was involved in a business activity and earned more than 10 per cent of its gross income from that business activity. It had business premises, and it participated in general commerce. Although there were no economic or other relevant reasons for interposing the bank into the investment structure, seemingly the bank would still be entitled to treaty benefits because its shares were traded substantially and regularly on a recognised stock exchange, or, at least, they were at the time of the case.

This result appears to be contrary to the policy of double tax treaties. The bank could not be considered to be the owner of the income in a substantive economic sense, regardless of the fact that it was involved in genuine business activity.

This analysis demonstrates that although the absence of business activity may establish that an intermediary is a mere conduit the converse is not necessarily true. The fact that

<sup>148</sup> Fr.-U.K. Convention, *supra* note 143.

<sup>149</sup> Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Fr., Aug. 31, 1994, 1963 U.N.T.S. 67.

an intermediary is involved in business activity does not necessarily show that it is not acting as a conduit or, to avoid the double negative, a company may act as a mere conduit even though it carries on substantive business activity.

## 7. REFORM AND CONCLUSION

### 7.1 The OECD Discussion Draft of April 29 2011

The question of conduit companies has remained under official review for some years. In 1987 the OECD published the Conduit Companies Report.<sup>150</sup> The Commentary to the OECD Model Tax Convention and the Model itself, are always the subject of study. On April 29, 2011 the OECD published a Discussion Draft on the Clarification of the Meaning of 'Beneficial Owner'.<sup>151</sup> However, it is submitted that, while reform is necessary, prospects of progress are modest at best if policy makers follow the approach in the discussion draft.

Among the fundamental problems that this article addresses, two stand out: the illogicality of accepting activity as an indicium of ownership; and the problem of deciding between legal and substantive perspectives of corporations, especially corporations that act as conduit companies. As the authors read it, the OECD discussion draft of 2011<sup>152</sup> does not address the first of these problems, the illogicality of accepting activity as an indicium of ownership. In short, the discussion draft does not address the subject-matter of this article. The draft thus hobbles its attempts to clarify the meaning of 'beneficial owner' by failing to address the fundamental illogicality of a test—substantive business activity—that, as this article demonstrates, is a major component of existing attempts to clarify that meaning. This shortcoming of the draft leads the authors to conclude that the draft is likely to shed only limited light on the subject that it addresses.

### 7.2 The Discussion Draft and Corporate Personality

While it does not say much about the test of substantive business activity, the draft does, at least indirectly, address a related problem of the meaning of 'beneficial owner', namely the problem of whether treaty law must respect the corporate form, or should look past corporate form to discover whether owners of a company are entitled to treaty benefits as residents of one of the states that are parties to the treaty in question. This article adverts to that problem in Part 1.2. Briefly to return to that issue, the authors add here a short comment on the manner in which the discussion draft addresses that issue.

While the draft does have something to say on the point, as the authors read it the draft is somewhat imprecise. One could make the point by referring to a number of parts of the draft, but analysis of some of the text of a single example suffices. Take draft paragraph 12.4, which explains that:

(1) The recipient of a dividend is the 'beneficial owner' of that dividend where he has the full right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass the payment on to another person. [Note in passing the false dichotomy between 'contractual' and 'legal'. What obligation is 'contractual' but not 'legal'?] (2) Such an obligation will

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<sup>150</sup> *Conduit Companies Report*, *supra* note 14.

<sup>151</sup> OECD COMMITTEE ON FISCAL AFFAIRS, *supra* note 25.

<sup>152</sup> *Id.*

normally derive from relevant legal documents (3) but may also be found to exist on the basis of facts and circumstances ... showing that, in substance, the recipient clearly does not have the full right to use and enjoy the dividend; (4) also, the use and enjoyment of a dividend must be distinguished from legal ownership .... [Numbers added for purposes of discussion].

Let us call each numbered section a 'text'. Text 1, referring to enjoyment, defines 'beneficial ownership' in terms of legal ownership. But text 4 says that enjoyment of a dividend must be distinguished from legal ownership. Text 3 tells us that enjoyment may exist as a matter of fact, without legal rights

The observation in text 3 is helpful until one compares text 3 with text 1, since text 3 seems to suggest that full factual enjoyment is correctly called 'beneficial ownership', and until one at the same time compares text 3 with draft paragraph 12.5, which says that, 'The concept of 'beneficial owner' deals with some forms of tax avoidance (i.e., those involving the interposition of a recipient who is obliged to pass the dividend to someone else) ...'. That is, draft paragraph 12.5 uses 'beneficial owner' to refer to a legal owner who is nevertheless obliged to act as a conduit.

Now compare text 1, on one hand, with text 2 and text 3 on the other. Text 1 refers to a recipient who enjoys a category of benefit that is 'unconstrained by a contractual or legal obligation'. That is, text 1 locates itself in the context of legal obligations and legal freedoms and powers. The recipient has legal freedom or power to enjoy the dividend and no inconsistent legal obligation constrains that freedom or power. Text 2 occupies the same territory; the recipient derives her freedoms and powers from 'relevant legal documents'. In contrast, text 3 identifies an agent (in the sense of an actor, not in the legal sense of the complement of a principal) who is not the recipient but who, nevertheless, enjoys dominion over the dividends in question. Unlike the recipients in texts 1 and 2, the recipient in text 3 does not enjoy such dominion; instead, the recipient is subject to an obligation to pass the dividend on to the agent. But text 3's enjoyment by the agent is not based in law; the enjoyment is factual and circumstantial, in short, substantive. Likewise, for reasons of substance, not of law, the recipient itself does not enjoy dominion over the dividends that it receives. That is, text 2 and text 3 address concepts that differ (law and substance) and address recipients that differ in respect of the dominion that they enjoy over dividends that they receive: dominion for the recipient in respect of text 2, but no dominion in respect of text 3.

The inference to be drawn from the analysis in the previous paragraph is that the categories that are the subjects of text 2 and text 3 can be interpreted sensibly only as mutually exclusive sub-sets of the category that is the subject of text 1. But this inference makes sense in respect of text 2 only. The subject matter of text 1 locates itself in the territory of law, as does the subject matter of text 2. That is, text 2 can logically form a sub-set of text 1. But the subject matter of text 3 relates to fact, circumstance, and substance, not to law. The subject matter of text 3 cannot be a sub-set of the subject matter of text 1, either linguistically or logically.

It is not enough to say in defence of the draft, 'The language may be loose, but we know what the Committee on Fiscal Affairs intends'. As first sight, that may appear to be so. But the analysis in the foregoing paragraphs shows that no, the draft is not coherent enough for us to know what the Committee intends; the Committee's meaning slides elusively from one signification to another. This result is unsurprising. When people

try to use the same language to express opposing concepts confusion is almost inevitable.

Is the criticism in the preceding paragraphs ungenerous? The Committee on Fiscal Affairs does its best with the weapons available to it. But the sword of beneficial ownership shatters on the anvil of corporate personality. If one tries to reduce this area of the law to anything resembling a rule or series of rules felicitous results are unlikely.

### 7.3 Conclusion

Although different reports of the OECD and courts substitute the substantive business activity test for the beneficial ownership test, that test is not related to the concept of ownership at all.

Originally, courts applied the substantive business activity test to cases involving straw companies and base companies. The focal issue in those cases is whether a corporation should be recognised for tax purposes. Courts considering base companies and straw companies considered the presence of substantive business activity to be sufficient to recognise a corporation as a separate taxable entity. Conduit company cases *prima facie* appear similar to straw company cases and base company cases. Probably for this reason, some courts have applied the test of substantive business activity to conduit company cases by transplanting the reasoning adopted in cases involving straw companies and base companies.

Unlike cases involving straw companies and base companies conduit company cases should be determined in the light of the object and purpose of double tax treaties. Although the absence of a business activity indicates that the interposition of an intermediary lacks substance for the purpose of qualifying for treaty benefits, its presence does not necessarily indicate that the interposition of an intermediary does not contradict the object and purpose of a double tax treaty. It follows that the business activity criterion works best as a one-way test in conduit company cases: no business activity, no treaty benefit. But the test cannot logically be applied to qualify a company for treaty benefits.

### 7.4 Coda

This article is part of a larger project. In work to follow, the authors plan to address related topics, which include:

- The surrogate test of dominion.
- Interpretation of beneficial ownership provisions as non-specific anti-avoidance provisions.
- Limitation of benefits provisions.
- Medium and long-term solutions to the problem of conduit companies.

The authors will argue that the medium-term solution is to interpret ‘beneficial ownership’ according to the apparent objective of those who introduced the concept into the text of the OECD Model Convention. That objective was not to introduce a formal, technical, test. Rather, it was to prevent residents of third countries from contriving to take advantage of tax benefits that states that are parties to double tax



treaties intend to confer on and to limit to their own residents.<sup>153</sup> The objective may be achieved by interpreting beneficial ownership provisions as anti-avoidance rules, following reasoning reminiscent to the reasoning of the Swiss Federal Court in *A Holding ApS v Federal Tax Administration*,<sup>154</sup> which is discussed in part 2 of this article.

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<sup>153</sup> ‘Extracts from OECD Working Documents of 1968 to 1971 in respect of Beneficial Ownership’, being an appendix to a Response by John Avery Jones, Richard Vann, and Joanna Wheeler to ‘OECD Discussion Draft, ‘Clarification of the Meaning of ‘Beneficial Owner’ in the OECD Model Tax Convention’, available at <http://www.OECD.org/tax/taxtreaties/publiccommentsreceivedonthediscussiondraftonthemeaningofbeneficialownerintheOECDmodeltaxconvention.htm>, last accessed Aug. 31 2012.

<sup>154</sup> *A Holding ApS v. Fed. Tax Admin.*, 8 I.T.L.R. 536 (2005) (Federal Court, Switz.).

# Too rich to rein in? The under-utilised wealth tax base

Natalia Chatalova<sup>1</sup> and Chris Evans<sup>2</sup>

## **Abstract**

Taxes on wealth have never been as popular or widespread as taxes on the other two major tax bases – income and expenditure. Virtually every country around the world uses income taxes and most also use expenditure taxes. These two tax bases account for the vast majority of tax revenue for most countries. On the other hand, wealth taxes, where they do exist, account for relatively small amounts of total tax revenue.

This article considers the use – or more often the under-use – of wealth taxes in developed and developing countries. It includes a discussion of different forms of wealth taxation together with the theoretical underpinnings and the practical problems that can arise when such taxes are implemented. Trends in different types of jurisdiction are analysed and both country-specific and more universal wealth tax policy changes are identified. Finally, some thoughts on the likely future policy directions in wealth taxation are presented.

## **1. INTRODUCTION**

Wealth is not about having a lot of money; it's about having a lot of options.

Chris Rock, US Comedian

Of the three traditionally accepted tax bases – income, expenditure and capital/wealth<sup>3</sup> – the latter is by far the least used in the tax systems of both developed and developing countries. Virtually every country around the world uses income taxes (whether on individuals, companies or other entities). Most also use expenditure taxes (such as the value added tax which appears in some form or another in most developed countries, or the customs and excise duties that are likely to be more relied upon in developing

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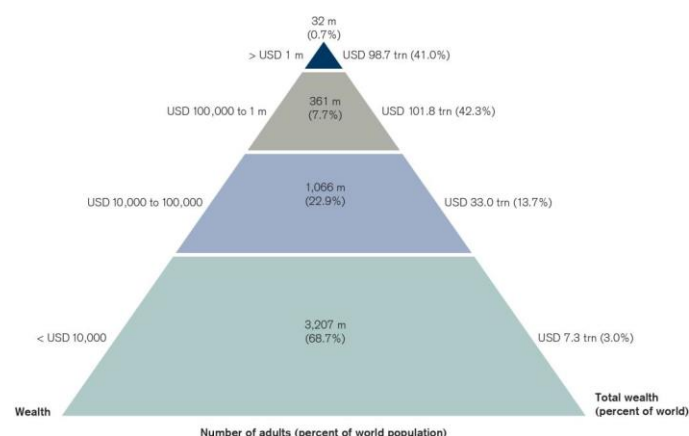
<sup>3</sup> As noted by Sandford (Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 94), ‘capital’ and ‘wealth’ are terms which can be used interchangeably. Economists tend to think of capital as a stock of assets to be used for future production and wealth as a stock of assets to be drawn on for consumption - but the assets are the same.

countries). Between them, these two tax bases (income and expenditure) account for the vast majority of tax revenue for most countries. But taxes on wealth have never been as popular or widespread as taxes on the other two major tax bases.

It is not entirely surprising that the wealth tax base is relatively under-utilised compared to its more illustrious income and expenditure counterparts. Not only, it is argued, can wealth taxes have a negative impact upon entrepreneurial activity and economic growth, but the biggest problems of wealth taxes are the practical administrative issues (particularly related to disclosure and valuation) that are often evident when attempts are made to tax accumulations and/or transfers of capital or wealth. Thus, these taxes are not an obvious universal tax policy tool.

In spite of the practical problems and efficiency issues of wealth taxes, those in favour of attempts to tax wealth typically garner significant support. The main reason is the embedded inequality of wealth. Figure 1, for example, shows that 41 per cent of the world's wealth is held by just 0.7 per cent of the world's population, and such statistics would readily be used by wealth tax advocates to justify the imposition or retention of wealth taxes designed to effect appropriate re-distribution.

**Figure 1. The Global Wealth Pyramid**



Source: Global Wealth Databook 2013, Credit Suisse.

The ambivalence towards wealth taxes was neatly summarised in the United Kingdom's (UK's) Mirrlees Review, which noted that:

Taxation of wealth is a topic that excites strong passions. Some view it as the most direct means of effecting redistribution and key to achieving equality of opportunity. Others see it as the unjustified confiscation of private property by the state. Given these opposing viewpoints it is not surprising that this is an area of taxation where international practice differs dramatically....Some countries levy taxes directly upon wealth holdings while others only tax transfers of wealth. There are some countries which do not tax wealth at all.<sup>4</sup>

<sup>4</sup> Mirrlees, James, Adam, Stuart, Besley, Tim, Blundell, Richard, Bond, Stephen, Chote, Robert, Gammie, Malcolm, Johnson, Paul, Myles, Gareth and James Poterba, *Tax by Design* (The Mirrlees Review) (Institute for Fiscal Studies, 2011) 347.

Such diverging views have contributed to major differences between countries in the use of wealth taxes, their scope, their effectiveness and their political and opportunity costs. Wealth taxes have seen different levels of commitment and different levels of success across jurisdictions. Many developed countries have reduced the scope of wealth taxation by narrowing the tax base or have abandoned this tax source altogether, whilst increasing their reliance on other tax bases. Contrastingly, several developing countries continue to use wealth taxes in attempts to capture ‘some’ taxation revenue to address the significant inequality in the distributions of income and wealth among their citizens.

This article considers the use – or more often the under-use – of wealth taxes in developed and developing countries. It includes a discussion (in Section 2) of different forms of wealth taxation together with the theoretical underpinnings and the practical problems that can arise when such taxes are implemented. Next, the current role of wealth taxation is discussed in Section 3. Trends in developed and transitional or developing jurisdictions are analysed and both country-specific and more universal wealth tax policy changes are identified. Finally, some thoughts on the likely future policy directions in wealth taxation are presented.

## 2. CONCEPTUAL ISSUES

### 2.1 Forms of Wealth Taxation

If wealth is not easily measured, it is certainly well understood by those who enjoy it and those who do not. The essential characteristic of a capital or wealth tax is that, in principle, it relates to the whole range or genus of assets, whether tangible or intangible: cash and bank balances; real property such as houses; personal property such as jewellery, pictures, furniture, cars and boats; stocks and shares; and business assets. All these assets, taken together, comprise the tax base of any form of wealth tax, unless expressly excluded.<sup>5</sup> To try to encapsulate the taxpayer’s wealth for tax purposes, a taxpayer’s net wealth is usually relevant. This ‘net wealth’ is typically computed by subtracting a taxpayer’s total liabilities from total assets.<sup>6</sup>

Wealth taxes can be grouped into three major categories: taxes on the holding or stock of wealth; on the transfer of wealth; and on wealth appreciation.<sup>7</sup> The first category comprises the taxes levied periodically on a taxpayer’s aggregate net wealth.<sup>8</sup> These taxes can be ongoing annual wealth taxes (‘AWT’), such as those currently levied on individuals in France, Norway, Switzerland and India and on corporate entities in Luxembourg; or they may be sporadic capital levies, typically imposed at a time of national crisis or in the aftermath of a major disaster or upheaval, such as was the case

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<sup>5</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 94.

<sup>6</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 94.

<sup>7</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 95.

<sup>8</sup> Rudnick, Rebecca S. and Richard K. Gordon, ‘Taxation of Wealth’ in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol 1, ch 10, 1.

in Japan after the Second World War. Both AWTs and once-off capital levies are relatively uncommon in both developed and developing tax systems.<sup>9</sup>

The second category of wealth taxes comprises those taxes levied on the recipient or the transferor of net wealth, whether *inter vivos* or at death. These wealth transfer taxes therefore include gift taxes, inheritance taxes (when imposed on the recipient of wealth on the death of the transferor) and estate taxes (when the tax is levied on the estate of the deceased).<sup>10</sup> Typically these taxes are imposed at the time of the wealth transfer. Most OECD countries currently have such transfer taxes.<sup>11</sup>

The third category comprises taxes on net wealth appreciation. These are taxes such as the capital gains tax ('CGT'). These taxes are typically imposed when the asset sale or another realisation event takes place and there is a realised increase in the net wealth of the taxpayer. Again, most OECD (and, indeed, most non-OECD) countries have forms of CGT currently in operation.<sup>12</sup> Arguably, however, such taxes on the appreciation of capital can be considered as part of the income base (effectively capital income, not dissimilar to dividends, rental returns, interest income and other forms of capital return). Moreover, there are significant difficulties in comparing CGT regimes due to vast differences in their detail and practical application.<sup>13</sup> For these reasons, and because there is generally a lack of directly comparable data which would allow more robust analysis, CGT regimes (or other taxes on wealth appreciation) are not discussed further in the following sections.

In addition to the obvious distinctions in the form of wealth taxes already identified, there can also be significant variations in the nature of the tax base, in the tax units upon which the taxes are levied, and in the tax rates that are imposed upon the base and unit.

## 2.2 The Tax Base for Wealth Taxes

A vital question in wealth taxation is how far the tax authorities should extend their taxing rights. That is, what is the appropriate tax base? Practical approaches vary, as will be shown in Section 3. In part this is because countries have recognised that unless a wealth tax is applied on a worldwide basis, moving mobile assets offshore or entering into schemes to 'hide' assets is attractive to the taxpayers. The wealth tax base is therefore typically selected to be consistent with the country's tax base for income tax purposes. Moreover, for domestic assets, countries have often adopted a

<sup>9</sup> In 2010, only 3 out of 30 OECD countries (France, Norway and Switzerland) had a comprehensive annual wealth tax imposed on individuals: OECD, *Revenue Statistics 1965 – 2009* (OECD Publishing, 2010). Since then Iceland and Spain have re-introduced annual wealth taxes on a 'temporary' basis.

<sup>10</sup> Villios, Sylvia, 'An Inherited Wealth Tax for Australia? The Henry Recommendation 25 for a Bequest Tax', (2013) 22 *Revenue Law Journal* 1.

<sup>11</sup> In 2010, 20 out of 30 OECD countries had life **and** death transfer taxes; three member states (Austria, Belgium and Iceland) had death transfer taxes but no life transfer taxes; and one (New Zealand) simply had a life transfer tax (subsequently abolished). In most cases (the UK and the United States (US) were the exceptions) the death taxes were inheritance taxes with the tax levied on the beneficiaries of the estate: OECD, *Revenue Statistics 1965 – 2009* (OECD Publishing, 2010).

<sup>12</sup> In 2001, 112 out of 161 countries surveyed had CGT regimes in place: Cooper, Gordon and Chris Evans, *Cooper & Evans on CGT* (4<sup>th</sup> edition, Thomson Reuters, 2012), 11. The number will have increased since then: see, for example, OECD Tax Database, 'Corporate and Capital Income Taxes – 2012' <[www.oecd.org/ctp/tax-database](http://www.oecd.org/ctp/tax-database)> (Accessed on 21 January 2013).

<sup>13</sup> Evans, Chris and Cedric Sandford, 'Capital Gains Tax - The Unprincipled Tax' *British Tax Review* No 5 (1999) 387-405.

‘tax stops at the door’ mentality,<sup>14</sup> an approach also justified on privacy infringement grounds. But this means that those who hold a significant portion of their net wealth within their homes will be treated preferentially, with inevitable adverse horizontal equity and efficiency implications.

### 2.3 The Tax Unit for Wealth Taxes

The tax unit for wealth tax purposes may be a corporation, an individual, a couple, a family or variations on this. For the sake of administrative simplicity, the tax units where a wealth tax is employed are, again, often the same as those used by a country in its computation of income tax.

Cross jurisdictional experience suggests that significant problems arise with respect to the tax unit. A net wealth tax may be equitable for a family tax unit, but will be less so for an individual tax unit, particularly if this tax is applied progressively.<sup>15</sup> Once the tax unit is identified, attribution difficulties add further complexity. Attribution is necessary to ensure that there is no double taxation in the hands of a legal entity and the physical person. While this notion is a simple and reasonable construct, it is very problematic in practice.

### 2.4 The Tax Rates

In operation, the wealth tax liability is computed by applying country-specific flat or progressive tax rates to the amounts of wealth (stock or transfer) identified as the appropriate base.<sup>16</sup> The tax liability in case of transfer taxes can additionally vary, depending on the relationship of the recipient to the transferor (in the inheritance tax type of death duties). Further, the tax liability may attract a ‘discount’. This is often the case if the net increment in wealth is realised on an asset that has been held by a taxpayer over a long period of time.

From a cross-border standpoint, double tax treaties do not usually explicitly cover remedies for double taxation of net wealth or wealth transfers. Thus, where a taxpayer is subject to more than one form of wealth taxation in more than one jurisdiction, double taxation can arise, unless more general unilateral tax treaty reliefs are available to the taxpayer.

### 2.5 Policy Rationale

Governments impose taxes to raise revenue, tackle inequality and inequity, discourage harmful consumption or address negative externalities.<sup>17</sup>

The first of these – revenue raising capacity – is not commonly mentioned by those advocating wealth taxes, and all the evidence, explored in more detail in Section 3 below, supports such a conclusion. At best net worth taxes on the holding of wealth contribute a minute proportion of total tax revenue, and wealth transfer and wealth appreciation taxes hardly fare any better.

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<sup>14</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 109.

<sup>15</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 95.

<sup>16</sup> Eurostat, *Taxation Trends in the European Union* (Taxation and Customs Union, 2012) (‘Eurostat’).

<sup>17</sup> Rakowski, Eric, ‘Can Wealth Taxes be Justified?’ (1999) 53 *Tax Law Review* 1, 263.

Perhaps the strongest rationale for the introduction or continuation of taxes on wealth lies in the second of the objectives for governments when they impose taxes: their ability to positively impact upon the horizontal and vertical equity of the tax system. In 1953, Nicholas Kaldor summarised the rationale for use of wealth taxes as a taxable capacity differentiator.<sup>18</sup> This rationale has since become a frequently cited argument by those who advocate wealth taxes:

Equity for the [wealth] tax is that income taken by itself is an inadequate yardstick of taxable capacity...Capital and income constitute two distinct ... sources of spending power...a separate tax on each provides...a better yardstick of taxable capacity than either form of taxation itself.<sup>19</sup>

Characteristically, person A, who earns \$10 from a \$100 investment, all other things held constant, has greater taxable capacity than person B who earns \$10 from labour and has no investment.<sup>20</sup> Even if no money was earned on the investment by person A, he or she can monetise their holding. In this case, the imposition of a net wealth tax on person A would be vertically and horizontally equitable. Via the imposition of a net wealth tax, person A's greater taxable capacity is recognised. This is fair as it aims to reduce inequality among taxpayers. A fair tax should improve the perception of equality among taxpayers, leading to greater trust in institutions and higher levels of solidarity.<sup>21</sup>

When a wealth transfer tax is applied to intergenerational wealth transfers, it is also a fair tax. By placing relatively higher burdens on higher wealth transfers, this tax plays a role in tackling intergenerational inequality. This is because the quantum of physical disposable wealth of the heirs is proportionally reduced by the corresponding wealth transfer tax liability imposed at the time of the transfer. The imposition of this liability can also enhance social equality, especially when the tax is applied progressively.<sup>22</sup> Therefore, like a net wealth tax, a wealth transfer tax has sound theoretical policy groundings as a result of its re-distributional properties.

Efficiency is also a frequently cited rationale for wealth taxes. When low yielding assets are subject to a wealth tax, taxpayers are incentivised to convert those low yielding assets into higher yielding assets.<sup>23</sup> It is argued that taxpayers will have the desire to generate greater rates of return on their wealth in order to prevent its erosion. This contributes to increased efficiency of asset utilisation. Wealth taxes can also improve the incentives to work, since, unlike taxation of income, productive activities are not penalised by the taxation of wealth.<sup>24</sup> Ironically, the conversion of wealth into higher yielding assets and increased productivity of wealth holders can, in turn, lead to greater inequality. This is because high returns may be realised on wealth

<sup>18</sup> Glennerster, Howard, 'Why was the Wealth Tax for the UK Abandoned? Lessons for the Policy Process and Tackling Wealth Inequality', (2012) 41 *Journal of Social Policy* 2.

<sup>19</sup> Kaldor, N., *An Expenditure Tax* (Allen and Urwin, 1953), 53.

<sup>20</sup> This example is a simplification of an example in Rudnick, Rebecca S. and Richard K. Gordon, 'Taxation of Wealth' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol 1, ch 10, 3.

<sup>21</sup> Bird, Richard M., and Eric M. Zolt, 'Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries' (2014) 15 *Annals of Economics and Finance* 2.

<sup>22</sup> Ryan, Kerry A. 'Human Capital and Transfer Taxation' (2009) 62 *Oklahoma Law Review* 264-270.

<sup>23</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 108.

<sup>24</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 108.

reinvestment or on human capital to the benefit of the wealth holder only. Therefore, this argument relies on creation of extraneous benefits for people other than the wealth holder.<sup>25</sup> An example of such benefits is reinvestment in productive assets that leads to job creation or economic growth.

Although there are a number of administrative arguments against wealth taxes (discussed below), policymakers advocating these taxes are still able to identify other, indirect, administrative benefits of wealth taxes.<sup>26</sup> These benefits include the potential for reduction of tax avoidance and evasion, when wealth taxation complements income taxation. In this respect, governments can collect wealth tax data and cross check it against income tax data to ensure greater compliance and that any legislative loopholes in either wealth or income taxation are not exploited.<sup>27</sup>

These arguments suggest that wealth taxation can be a useful policy tool, at least in theory. The arguments are also politically appealing as the wealth tax burden is placed on the more affluent sectors of the population. Nonetheless those who argue against wealth taxes are still able to enlist significant support, based upon major concerns relating to valuation, disclosure and appropriate attribution of legal and practical liability.

## 2.6 Problems with Wealth Taxation

Two main administrative problems – disclosure and valuation – prevent wealth taxes being more prevalent than otherwise might be the case.

In order for wealth taxation to be successful, a country's legislation needs to ensure that taxpayers disclose their wealth and cannot enter into simple and cost effective schemes to optically reduce the overall value of that wealth.<sup>28</sup> The problem of disclosure is obvious – it is very easy to hide or export many forms of wealth, whether in the form of physical assets like diamonds or fungible assets like bank balances. Compliance becomes a real problem; hence inequities begin to arise between honest and dishonest taxpayers; and revenue authorities introduce compromises (such as exempting household articles) which inevitably undermine the efficiency, equity and integrity of the tax.

Where wealth is undisclosed or diminished, effective taxation of wealth is not possible. With this in mind, policy makers must recognise that particular taxpayers may be more likely to evade or avoid a wealth tax. An interesting example is the case of the Swedish AWT that was in force until 2007. Research has indicated that this tax was subject to more evasion by households with higher cognitive ability.<sup>29</sup> This trend

<sup>25</sup> Rakowski, Eric, 'Can Wealth Taxes be Justified?' (1999) 53 *Tax Law Review* 1, 263.

<sup>26</sup> Boskin, Michael J, 'An Economist's Perspective on Estate Taxation' in *Death, Taxes, Family and Property*, Edward C. Halbach (Jr) (ed) (West Publishing, 1977) cited in McCaffery, Edward J., 'The Uneasy Case for Wealth Taxation' (1994) 104 *Yale Law Journal* 283.

<sup>27</sup> Gutman, Harry L., 'Reforming Federal Wealth Taxes after ERTA' (1983) 69 *Virginia Law Review* 7, 1185–1186.

<sup>28</sup> Taxpayers have been creative in schemes even if a no wealth tax was in force at the particular point in time. See, for example, Ingram, Judith, and Loraine Watson, 'IRC v. McGuckian' (1995) 2 *British Tax Review* 183–193. This article discusses the case of Mr McGuckian, who was a party to a scheme that was designed to reduce the value of shares held by him as he feared a wealth tax might be introduced in the UK.

<sup>29</sup> Seim, David, 'Wealth Taxation, Evasion and Cognitive Skills: Evidence from Sweden' (2012, Stockholm University Working Paper).



is likely to be present in other developed countries and, intuitively, this trend would be expected to be even more pronounced in developing and transitional economies.

Asset disclosure is accompanied by an additional major problem: its valuation, especially where an actual sale of the asset does not take place to give an independent market value. In addition, if a wealth tax is to have any consistency of meaning, assets such as the capitalised value of future pension rights, or of future earning power, may need to be included in the tax base. But there is no consensus on whether they should be included, and if so, how they should be measured.

Valuation difficulties are notably seen in cases of unlisted assets when particular interests are held through companies, partnerships, trusts, or other entities.<sup>30</sup> This is because each interest needs to be valued. Here, issues such as control premiums and/or minority discounts are evident. Additional concerns appear where different valuations are used for different tax purposes, as in France.<sup>31</sup> These problems are naturally magnified for intangible property.

Wealth attribution glitches are observed when different legal ownership forms are considered. For instance, while the common law trust structure is widely used in the UK, it does not exist in many civil law countries such as France.<sup>32</sup> Attribution needs to deal with structures whose legal notions do not overlap across jurisdictions, particularly if wealth is taxed on a worldwide basis. Problems with beneficiaries that have no full right to enjoy particular benefits conferred on by 'shared' wealth are prevalent. In some developing countries, such as Indonesia, these issues are more prolific, as property is often vested in an entire community.<sup>33</sup> Realistically, net wealth or transfer taxes are exceptionally difficult, if not impossible, to operate successfully when community or familial ownership titles are in place.

Identification of the nature of interest creates another set of difficulties. Pension funds are good example. Although a taxpayer's pension fund holding is identifiable, it is often not accessible until a particular age.<sup>34</sup> As a result, some countries have chosen to exempt such entities. But, pension funds are an important component of a taxpayer's net wealth. So, distortionary inefficiencies would arise if, due to tax reasons, wealth is accumulated via pension funds.

Motivated by wealth preservation, high net worth individuals ('HNWIs') often look to move to a tax efficient jurisdiction.<sup>35</sup> In this respect, countries employ policies to effectively hinder tax driven migration. Some countries, such as Belgium, attempt to orient their tax policy such that the country is an attractive base for HNWIs. While Belgium has one of the highest burdens of labour income tax in the OECD, it is

<sup>30</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 94.

<sup>31</sup> Deloitte Touche Tohmatsu Limited, *France Highlights 2012* (Deloitte Global Services Limited, 2012).

<sup>32</sup> Deloitte Touche Tohmatsu Limited, *France Highlights 2012* (Deloitte Global Services Limited, 2012).

<sup>33</sup> Sandford, Cedric, *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation* (Fiscal Publications, 2000), 94.

<sup>34</sup> Beer, Yishai (1995) 'Taxation of Non-Profit Organizations: Towards Efficient Tax Rules', 2 *British Tax Review* 156-172. See also above n 5.

<sup>35</sup> Van Zantbeek, Anton, 'Tax-Driven Relocation of High Net Worth Individuals: Where to Run to?' (2010) 5 *European Taxation* 1.

essentially a tax haven for investment income.<sup>36</sup> This is arguably inequitable toward labour income earners. However, it is a workable way to retain HNWIs.

Other countries seek to impose tax barriers such as exit taxes or other penalties to prevent HNWIs from leaving the country.<sup>37</sup> For example, in the US, HNWIs cannot renounce citizenship or terminate long-term residence status in order to avoid paying US taxes.<sup>38</sup> If they do so, particular wealth transfer taxes continue to apply.<sup>39</sup> France also imposes exit barriers in the operation of its inheritance taxes. In that country, HNWIs leaving the country do so in vain if the heirs remain in France because French domestic laws contain explicit provisions for continual inheritance taxing rights.

One final argument used against wealth taxes is that there may also be a greater administrative burden imposed upon revenue authorities in collecting wealth taxes, relative to, for example, a value added tax,<sup>40</sup> although this may be mitigated – to some extent – by relatively lower costs of compliance for the taxpayers involved.<sup>41</sup>

Notwithstanding these real problems with the implementation and operation of taxes on wealth, and the political controversy that often surrounds them, the powerful equity and efficiency arguments already identified mean that wealth taxes are still used in many developed and developing countries. The following section identifies how and where they are so used.

### 3. CURRENT GLOBAL PRACTICES IN WEALTH TAXATION

#### 3.1 Overview

There are different combinations of wealth taxation forms used globally. The basic divergence stems from distinctions in historical, geographical, cultural and economic backgrounds. At the one extreme, tax havens such as the Cayman Islands, Monaco and Belize do not levy any form of wealth taxes. These small countries have traditionally differentiated themselves through their tax policy as attractive holding jurisdictions for the coffers of the wealthy.<sup>42</sup> Middle Eastern countries, such as the United Arab Emirates, also do not levy wealth taxes.<sup>43</sup> These countries have sought to attract foreign direct investment by implementing taxpayer friendly investment regimes in order to diversify their economies. At the other extreme, very few, mainly Western European, countries apply wealth taxes on both stocks and transfers of

<sup>36</sup> Van Zantbeek, Anton, 'Tax-Driven Relocation of High Net Worth Individuals: Where to Run to?' (2010) 5 *European Taxation* 1.

<sup>37</sup> Van Zantbeek, Anton, 'Tax-Driven Relocation of High Net Worth Individuals: Where to Run to?' (2010) 5 *European Taxation* 1.

<sup>38</sup> Van Zantbeek, Anton, 'Tax-Driven Relocation of High Net Worth Individuals: Where to Run to?' (2010) 5 *European Taxation* 1.

<sup>39</sup> Toder, Eric, 'International Competitiveness: Who Competes against Whom and for What?' (Urban-Brookings Tax Policy Centre Report, 2012).

<sup>40</sup> Brunner, Johann K., Eckerstorfer, Paul and Susanne Pech, 'Optimal Taxes on Wealth and Consumption in the Presence of Tax Evasion' (2010, The Austrian Centre for Labour Economics and the Analysis of the Welfare State, Working Paper No. 1003).

<sup>41</sup> Evans, Chris 'Taxation Compliance and Administrative Costs: An Overview', in *Tax Compliance Costs for Companies in an Enlarged European Community*, (edited Lang M, Obermair C, Schuch J, Starlinger C and Weninger P, Kluwer Law International, 2008) 447-468.

<sup>42</sup> Assogbavi, Tov and Sébastien Azondékon, 'Tax Havens: Toward an Optimal Selection Approach Based on Multicriteria Analysis' (2009) 7 *International Business & Economics Research Journal* 11, 9.

<sup>43</sup> Ernst & Young, *International Estate and Inheritance Tax Guide* (Ernst & Young Tax, 2012).

wealth – and even fewer on all three forms of wealth tax. These include some of the earliest adopters of wealth taxes globally, namely, France, Switzerland and Norway.<sup>44</sup>

In terms of specific sub-categories, transfer taxes are currently more common than net wealth taxes. This is because uncovering wealth is typically easier when the wealth transfer takes place when the legal documents tied to the transfer stipulate entitlement and value.<sup>45</sup> Transfer taxes are presently levied in more than half of the OECD nations and are most prevalent among the European Union members. Estate taxes are more likely to exist in common law countries, whereas inheritance taxes are predominant in civil law countries. The tax family and succession law differences lie at the root of this divergence.<sup>46</sup> Some of the most important developing and transitional economies, including China and Russia,<sup>47</sup> do not levy any wealth transfer taxes.

### 3.2 Developed Countries: Changes and Trends

Wealth is spread far more unequally than income.<sup>48</sup> Yet, in the OECD, wealth has not been targeted as a key source of tax revenue. OECD countries have historically raised relatively little revenue via net wealth and transfer taxes. Over the past 10 years, with the exception of Luxembourg and Switzerland, no OECD country has raised more than 2.5 per cent of their total tax revenue ('TTR') via these two tax categories in any one year.<sup>49</sup> Indeed, Belgium, France, Hungary, Iceland, Korea, Luxembourg, Norway and Switzerland are the only OECD countries to currently collect more than 1 per cent of TTR via net wealth and transfer taxes.<sup>50</sup>

Analysis of net wealth and transfer taxes from a GDP perspective paints a similar picture. The OECD average from both of these tax categories (combined) peaked at 0.51 per cent of GDP (1969), with the latest reported comparable measure equal to only 0.30 per cent of GDP (2010).<sup>51</sup> Figure 2 illustrates the time series of total net wealth and transfer taxes as a percentage of GDP. Luxembourg and Switzerland are excluded from the OECD maximum and are shown separately.

<sup>44</sup> Ernst & Young, *International Estate and Inheritance Tax Guide* (Ernst & Young Tax, 2012).

<sup>45</sup> Cremer, Helmuth and Pierre Pestieau, 'The Tax Treatment of Intergenerational Wealth Transfers' (Paper presented at the CESifo Venice Summer Institute Workshop on Taxation and the Family, 24-26 July 2004).

<sup>46</sup> Boadway, Robin, Chamberlain, Emma and Carl Emmerson, 'The Taxation of Wealth and Wealth Transfers', in Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, (Oxford University Press for Institute for Fiscal Studies, 2010).

<sup>47</sup> A draft rule was issued in China in 2012 for a possible inheritance tax but to date an inheritance tax has not been imposed. See Ernst & Young, *International Estate and Inheritance Tax Guide* (Ernst & Young Tax, 2012).

<sup>48</sup> OECD, *Growing Unequal Income Distribution and Poverty in OECD Countries* (OECD, 2008).

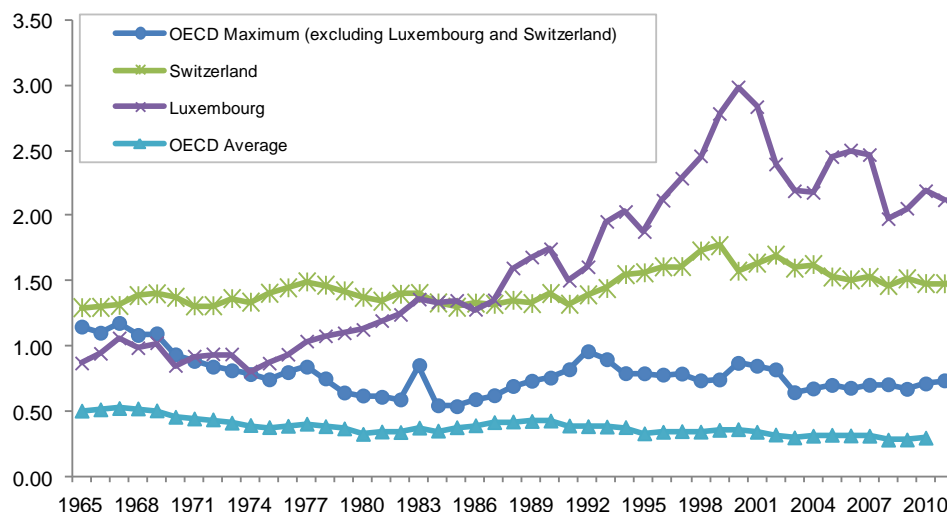
<sup>49</sup> OECD Tax Database, 'Revenue Statistics: Comparative Tables' < [http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables\\_data-00262-en](http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables_data-00262-en) > (Accessed on 21 January 2013).

<sup>50</sup> OECD, *Revenue Statistics 1965 – 2011* (OECD Publishing, 2012).

<sup>51</sup> OECD, *Revenue Statistics 1965 – 2011* (OECD Publishing, 2012).

**Figure 2: OECD Time Series of Net Wealth Taxes plus Transfer Taxes as Percentage of GDP<sup>52</sup>**

% of GDP



Source: OECD, *Revenue Statistics 1965 – 2011* (OECD Publishing, 2012).

From Figure 2, it is clear that net wealth and wealth transfer taxes collected by OECD countries, on average, are relatively very low and have declined in significance over time. This has occurred in spite of increasing aggregate tax revenues (as a percentage of GDP) across the majority of OECD countries over the equivalent period. The fall in the relative importance of net wealth and wealth transfer taxes is not unexpected. Broader base consumption and income taxes have become more widespread among the OECD members. This is due to their ‘automatic’ built in growth attributes that come through with nominal rises in wages and prices of consumer goods as well as the relatively favourable administrative properties of these taxes.<sup>53</sup>

Revenue statistics suggest that little net wealth tax and wealth transfer tax revenue has been raised historically. For example, in the OECD the combined tax revenue derived by member countries from annual wealth taxes and wealth transfer taxes accounts, on average, for less than 1 per cent of their total tax revenue.<sup>54</sup> As little revenue has been raised, the redistributive power of these taxes has correspondingly been limited. It is consequently not surprising that the number of OECD countries using net wealth and transfer taxes has declined over time. This trend is evident across both federal countries and unitary countries in the OECD, with no significant differences in ‘stickiness’ of the use of net wealth taxes across the two different systems of government.

<sup>52</sup> OECD time series coded 4200 (Recurrent Taxes on Net Wealth), 4300 (Estate, Inheritance and Gift Taxes) and 4510 (Non-Recurrent Taxes on Net Wealth).

<sup>53</sup> Schellenbach, Jan, ‘The Economics of Taxing Net Wealth: A Survey of Issues’ (2012, University of Freiburg Working Paper No. 12/5).

<sup>54</sup> OECD, *Revenue Statistics 1965 – 2009* (OECD Publishing, 2010).

The form of wealth tax most commonly eliminated by the OECD members has been the AWT. A total of only five OECD countries still had this tax operating in a comprehensive form in 2011, a decline from a peak of 16 countries in 1995.<sup>55</sup> These taxes have reduced in popularity among the OECD members because, coupled with administrative difficulties, they have generated a low revenue yield and had an insignificant impact on progressivity. Germany and Sweden are examples of countries that have abandoned annual net wealth taxes in the past 15 years. In Sweden, the net wealth tax was eliminated as inconsistencies in the treatment of private wealth and operating assets lead to inefficient and inequitable outcomes.<sup>56</sup> In Germany, administrative and valuation issues were the cause of the demise of the AWT. Germany's Federal Constitutional Court went as far as to declare the net wealth tax that was in force at the time as unconstitutional.<sup>57</sup> Its reasoning was premised on the concern that different valuations for different kinds of property were in violation of equality of law principles.<sup>58</sup> Such differences and inconsistencies were manipulated by taxpayers who sought to minimise the tax burden within the letter of the law. Avoidance was a pertinent concern.

In comparison to net wealth taxes, wealth transfer taxes have been and continue to be used relatively more extensively by the OECD members. A total of 22 OECD countries have had at least one wealth transfer tax in operation in 2011.<sup>59</sup> This number has declined from its peak of 29 countries in 2005.<sup>60</sup> Australia, New Zealand and Canada are three of the countries that have abandoned wealth transfer taxes. In Australia, wealth transfer taxes were repealed in the late 1970s and early 1980s. Australia's estate taxes fell out of favour due to gaps in the law that gave rise to compliance issues.<sup>61</sup> Reality showed that even when Australia's wealth transfer tax rules were in force, discretionary trusts could be used to transfer wealth without any tax.<sup>62</sup> Schemes that took advantage of these vehicles were not uncommon especially among the most affluent taxpayers. Other problems identified were in relation to regressivity, such as the relatively high compliance costs of Australia's wealth transfer taxes for smaller estates.<sup>63</sup>

Canada gradually repealed its wealth transfer taxes over the course of the 1970s and 1980s.<sup>64</sup> As was the case in Australia, the major issues identified in the operation of

<sup>55</sup> OECD Tax Database, 'Revenue Statistics: Comparative Tables' < [http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables\\_data-00262-en](http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables_data-00262-en) > (Accessed on 21 January 2013).

<sup>56</sup> Silfverberg, Christer, 'The Swedish Net Wealth Tax – Main Features and Problems' (2009, The Stockholm Institute of Scandinavian Law).

<sup>57</sup> Silfverberg, Christer, 'The Swedish Net Wealth Tax – Main Features and Problems' (2009, The Stockholm Institute of Scandinavian Law).

<sup>58</sup> Silfverberg, Christer, 'The Swedish Net Wealth Tax – Main Features and Problems' (2009, The Stockholm Institute of Scandinavian Law).

<sup>59</sup> OECD Tax Database, 'Revenue Statistics: Comparative Tables' < [http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables\\_data-00262-en](http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables_data-00262-en) > (Accessed on 21 January 2013).

<sup>60</sup> OECD Tax Database, 'Revenue Statistics: Comparative Tables' < [http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables\\_data-00262-en](http://www.oecd-ilibrary.org/taxation/data/revenue-statistics/comparative-tables_data-00262-en) > (Accessed on 21 January 2013).

<sup>61</sup> Duff, David G. 'The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia and New Zealand' (2005, Berkley Electronic Press) < <http://law.bepress.com/expresso/eps/611> >.

<sup>62</sup> Duff, David G. 'The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia and New Zealand' (2005, Berkley Electronic Press) < <http://law.bepress.com/expresso/eps/611> >.

<sup>63</sup> Duff, David G. 'The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia and New Zealand' (2005, Berkley Electronic Press) < <http://law.bepress.com/expresso/eps/611> >.

<sup>64</sup> It is important to note that after the abolition of Canada's inheritance taxes, Canada imposed a realized capital gains tax at death. Some authors have compared to a 'de facto' inheritance tax. See Gans, Joshua S., and Andrew Leigh, 'Did the Death of Australian Inheritance Taxes Affect Deaths?' (2006, The

Canada's wealth transfer regime concerned complexity and avoidance.<sup>65</sup> New Zealand followed the trend set by Australia and Canada.<sup>66</sup> It initially broadened its estate transfer tax exemptions in 1979. As a result of this change, a significant portion of taxpayers fell out of New Zealand's estate tax net. For those who were still potentially subject to the tax, the free movement of people between Australia and New Zealand provided an escape route.<sup>67</sup> In the end, it proved too difficult and too costly for New Zealand to retain its estate taxes and it abolished these taxes entirely during the 1990s.

Capital drain and tax competition have been constant 'shadow' reasons for the elimination of both net wealth and wealth transfer taxes. For example, the Dutch decided to do away with the net wealth tax in 2001 as a result of concerns that it was a contributor to capital leaving the country. The Dutch also perceived this tax as a barrier to entry for foreign investors.<sup>68</sup> Capital drain was also Austria's secondary concern, when it eliminated its inheritance taxes in 2008.<sup>69</sup> This evidence suggests wealth taxes can impede efficiency in practice. Rather than investing into higher yield investments to preserve wealth as theory advocates, taxpayers simply move their wealth out of the jurisdiction that imposes a wealth tax.

Among the OECD countries where net wealth and transfer taxes been retained, two key trends have emerged. The first trend is that the net wealth and wealth transfer tax bases have been narrowed to ease the administrative burden. The second trend, again designed to ease the operating costs of the taxes, is that the manner of operation of these taxes has been simplified. For example, Germany, simplified its inheritance tax regime in 2008 due to perceived complexity of the rules prior to this reform. The Netherlands abolished its net wealth tax in 2001 but soon imposed a simpler 30 per cent capital tax on theoretical revenue of particular assets, net of corresponding liabilities.<sup>70</sup> This shift in the Netherlands' methodology looked to better capture the efficiency notion of wealth taxation.<sup>71</sup> It was said to be a policy that had superior alignment with the encouragement of entrepreneurial ventures.<sup>72</sup>

Given the evidence presented so far, changes to net wealth and wealth transfer tax policies are not isolated to specific jurisdictions. Based on the relatively short time frame in movement away from these taxes or at least their simplification, a domino effect across the OECD members has arguably been present. A number of OECD countries have either eliminated or simplified significant elements of their net wealth

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Australian National University Centre for Economic Policy Research Discussion Paper No.530). This tax continues to be in force for deemed dispositions of capital property, albeit it is a small earner.

<sup>65</sup> Gardner, Robert, 'Tax Reform and Class Interests: The Fate of Progressive Reform 1967-72' (1981) 3 *Canadian Taxation* 245.

<sup>66</sup> Barrett, Jonathan, 'Wealth Transfer Tax Redux?' (2011) 17 *New Zealand Journal of Taxation Law and Policy* 289.

<sup>67</sup> Barrett, Jonathan, 'Wealth Transfer Tax Redux?' (2011) 17 *New Zealand Journal of Taxation Law and Policy* 289.

<sup>68</sup> Heckly, Christophe, 'Wealth Taxes in Europe: Why the Downturn?' in Michel Taly and Gérard Mestrallet (eds), *Estate Taxation: Ideas for Reform*, (Paris Institut de L'Entreprise, 2004).

<sup>69</sup> Ernst & Young, *International Estate and Inheritance Tax Guide* (Ernst & Young Tax, 2012)..

<sup>70</sup> Heckly, Christophe, 'Wealth Taxes in Europe: Why the Downturn?' in Michel Taly and Gérard Mestrallet (eds), *Estate Taxation: Ideas for Reform*, (Paris Institut de L'Entreprise, 2004).

<sup>71</sup> Heckly, Christophe, 'Wealth Taxes in Europe: Why the Downturn?' in Michel Taly and Gérard Mestrallet (eds), *Estate Taxation: Ideas for Reform*, (Paris Institut de L'Entreprise, 2004).

<sup>72</sup> Chen D, Lee FC and J Mintz, 'Taxation of SMEs and Entrepreneurship' (2002, OECD Working Paper No 2002/09).

and wealth transfer tax regimes. This has been partly a result of the influence of the policies of neighbouring countries and partly a result of the broader tax competition pressures to retain and attract investment, especially from high net worth individuals. A good illustration of this is the Hong Kong Government's official explanation in eliminating its estate taxes: 'A number of countries in the region, including India, Malaysia, New Zealand and Australia, have abolished estate duty over the past 20 years. Hong Kong must not lose out in this race'.<sup>73</sup>

OECD countries that have moved away from wealth taxes have dealt with a potential revenue gap by securing tax revenue through broader tax bases in other areas of taxation. For example, in Figure 2, there is a decline observed for Luxembourg post 2006. This decline occurred as Luxembourg eliminated its individual AWT.<sup>74</sup> Luxembourg simultaneously introduced a 10 per cent withholding rate on interest from all individuals' savings to protect its overall tax revenues. Luxembourg moved to a simpler collection device via the withholding mechanism. Furthermore, Luxembourg eliminated the inefficient double taxation that was present under its previous AWT regime which levied the AWT at both the corporate and the individual levels.

In light of the key evidence described so far, is there any indication of the contrary? Have any countries been relatively more successful in their wealth tax experience and continue to use wealth as a tax base? Luxembourg and Switzerland are clear outliers in Figure 2. These two countries are wealthy, highly developed and have a small population base. Their personal income tax and indirect tax burdens for individuals are on the lower end of the OECD spectrum. From a political perspective, wealth taxes look palatable to the resident taxpayers who have accepted the small burden as an equitable liability.<sup>75</sup> Wealth taxes would also be relatively simpler to administer in these countries due to their small populations.

Nevertheless, a degree of caution is required in heralding success of these taxes in both Luxembourg and Switzerland. In spite of the relatively higher revenues derived, Luxembourg's and Switzerland's net wealth and wealth transfer taxes are still a relatively minor source of tax revenue.

Have any countries recently implemented net wealth taxes or transfer taxes? The answer is yes. After the global financial crisis, in 2009, Iceland reintroduced an annual net wealth tax.<sup>76</sup> This tax was implemented for a finite period. The temporary nature of the tax was used because under Iceland's previous regime, its taxpayers

<sup>73</sup> See the Inland Revenue Department (The Government of the Hong Kong Special Administrative Region), 'Revenue (Abolition of Estate Duty) Bill 2005 to be Gazetted on Friday' (Media Release, 4 May 2005) <<http://www.ird.gov.hk/eng/ppr/archives/05050401.htm>>.

<sup>74</sup> *Eurostat*, 123.

<sup>75</sup> This is particularly so for Switzerland. This is because its tax system developed from one that was based on wealth and property taxes with a gradual introduction of income taxes. See Avery Jones, John F., De Boe, Luc, Ellis, Maarten, J., Van Raad, Kees, Le Gall, Jean-Pierre, Goldberg, Sandford H., Killius, Jurgen, Maisto, Guglielmo, Miyatake, Toshio, Torrone, Henri, Vann, Richard J., Ward, David A., and Bertil Wilman, 'The Origins and Concepts and Expressions used in the OECD Model and their Adoption by States' 6 *British Tax Review* 695-765.

<sup>76</sup> Iceland previously abandoned its net wealth tax in 2006. See *Eurostat*, 172.

were more likely to leverage their assets to avoid the net wealth tax.<sup>77</sup> This leverage was partly responsible for Iceland's well known debt woes.

Spain also temporarily restored its net wealth tax in September 2011, amidst the Eurozone crisis. Spain was essentially forced to identify new tax revenue sources given its debt woes, austerity pressures, high unemployment and conditions imposed by the European Central Bank on provision of bailouts to Spain.<sup>78</sup> The success of Spain's reintroduced wealth tax will be closely scrutinised as its previous regime's loopholes led to widespread tax avoidance.<sup>79</sup>

In addition many countries have considered, or are considering, the introduction of narrower, or more partial, forms of wealth tax. Hence Hungary introduced, in January 2010, a partial wealth tax on luxury watercraft, aircraft and high performance passenger cars; more recently Cyprus has had to introduce a capital levy (a distinctive form of wealth tax on the holding of one aspect of wealth, in the form of bank savings) as part of its Eurozone bail-out arrangements in 2013; and the UK currently continues to debate (with apparently little chance of introduction) the merits of the so-called 'Mansions Tax' proposed by the minority partner party in the governing coalition.

Although the overwhelming trend is one of a movement away from net wealth taxes and, to a lesser extent, wealth transfer taxes, divergence among developed governments has occurred in times of economic uncertainty. The Spanish and Icelandic experiences show that governments can revive net wealth taxes. What is more interesting is that the revival can come without a significant time lag from the elimination of the tax. This is largely driven by pressures to shore up tax revenues in economies that hit recessionary environments. Expectantly, in those times, there are greater variances in economic priorities and country specific fiscal needs.

### 3.3 Transitional and Developing Countries: Changes and Trends

Little concrete evidence is available for developing and transitional economies in respect of wealth taxes. Many developing countries simply do not use net wealth or transfer taxes. This is partly due to their politicians' unwillingness to implement these taxes since a number of high powered government officials, their families and friends would fall under such a regime. Other developing countries that have these taxes in force have not derived meaningful revenues from them. This is because of the collection issues due to the lack of administrative resources to enforce laws and

<sup>77</sup> Daniel, Phillip, De Mooji, Ruud, Matherson, Thornton and Geerten Michelse, 'Iceland: Advancing Tax Reform and the Taxation of Natural Resources' (2011, International Monetary Fund Country Report No. 11/138).

<sup>78</sup> Spain previously abandoned its net wealth tax in 2008. European Commission, 'Tax Reforms in EU Member States: Tax Policy Changes for Economic Growth and Fiscal Sustainability' (2012, Working Paper No. 34).

<sup>79</sup> Under Spain's previous net wealth tax regime, business owners frequently shifted their businesses to sectors that were exempt from net wealth tax for political reasons, in order to avoid net wealth taxation. This simply required the cost of shifting to the exempt sector to be less than the tax saving achieved. See Alvaredo, Facundo and Emmanuel Saez, 'Income and Wealth Concentration in Spain from a Historical and Fiscal Perspective' (2009) 7 *Journal of the European Economic Association* 5.



serious corruption issues. Overall, under half of developing and transitional countries currently use net wealth taxes and/or transfer taxes.<sup>80</sup>

The relatively sparse distribution of wealth taxes in developing countries is linked to their focus on ‘optimal’ revenue sources.<sup>81</sup> Developing countries have followed developed countries more readily in implementing taxes that were more ‘successful’ in developed countries. For instance, the value added tax has been somewhat embraced by developing countries as ‘the lesser of evils’.<sup>82</sup> The conundrum for developing countries has been that if wealth taxes have not brought about meaningful revenue and redistribution in developed countries, why should developing countries bother to implement a wealth tax regime?

One of the most interesting tax policy tools used in wealth taxation by developing countries is a corporate net wealth tax. A number of South American countries employ this tax mechanism as a minimum or a substitute tax to work in conjunction with income tax. It is often a minimum floor tax paid. This floor was introduced by these jurisdictions as they experienced prolific offshore income shifting by domestic entities that wanted to avoid income tax.<sup>83</sup> Further, these countries have significant cash economies. An instrument was needed to act as a safeguard to compensate for the income tax lost due to these factors.

Ecuador, Argentina, Guatemala, Peru, Dominican Republic and Uruguay all use a corporate net wealth tax. The revenue raised from this tax in these countries presently ranges between 0.6 per cent and 0.7 per cent of each country’s GDP.<sup>84</sup> While these statistics reflect relatively small amounts, the absolute tax revenue is important for these developing countries. This is especially so for Guatemala and the Dominican Republic where the current TTR to GDP ratio is below 15 per cent. This is a significant divergence from the experience of developed countries which are more successful in administering income tax. Developed countries do not have the same need for corporate net wealth taxes to serve as a tax floor.

So far as wealth transfer taxes are concerned, anecdotal evidence suggests enforcement and collection issues are significant in developing and transitional economies. Chile is a good case in point. This country uses an inheritance tax rate that can be as high as 35 per cent at the margin.<sup>85</sup> Its regime has been described as more detailed than the inheritance tax regimes of many developed countries.<sup>86</sup> Yet, the tax revenues collected by Chile from its inheritance tax are extremely low. In the past decade, these revenues averaged about \$60 million per annum or just 0.2 per cent

<sup>80</sup> Strawczynski, Michael, ‘The Optimal Inheritance Tax in the Presence of Investment in Education’ (2012, Hebrew University of Jerusalem Working Paper), 24.

<sup>81</sup> Strawczynski, Michael, ‘The Optimal Inheritance Tax in the Presence of Investment in Education’ (2012, Hebrew University of Jerusalem Working Paper), 24.

<sup>82</sup> Rakowski, Eric, ‘Can Wealth Taxes be Justified?’ (1999) 53 *Tax Law Review* 1, 263.

<sup>83</sup> Gómez Sabaini, Carlos, Juan and Juan Pablo Jiménez, ‘Tax Structure and Tax Evasion in Latin America’ (2012, United Nations Publication LC/L.3455).

<sup>84</sup> Gómez Sabaini, Carlos, Juan and Juan Pablo Jiménez, ‘Tax Structure and Tax Evasion in Latin America’ (2012, United Nations Publication LC/L.3455).

<sup>85</sup> Ernst & Young, *International Estate and Inheritance Tax Guide* (Ernst & Young Tax, 2012). As a caution, marginal comparisons are limited because they do not look to the progressivity of the system as a whole.

<sup>86</sup> López, Ramón, ‘Fiscal Policy in Chile: Promoting Fiscal Growth?’ (2011, The University of Maryland Working Paper No. 11-01).

of TTR.<sup>87</sup> Legal and illegal schemes have exploited Chile's tax base. Corruption of Chile's tax collectors has contributed to the low collection rates, particularly where large fortunes are transferred at the extreme concentrations of wealth.<sup>88</sup>

Like developed countries, some developing nations have moved away from net wealth and transfer taxes. Sri Lanka, India, Bangladesh, Pakistan and Indonesia have all abolished elements of wealth transfer taxes that were previously utilised.<sup>89</sup> In Sri Lanka, it was shown that when the broadest form of net wealth and transfer taxes was in force, these taxes were neither an effective revenue producer, nor an instrument to improve equality.<sup>90</sup> There, the compliance costs were said to outweigh the benefits derived.

Recognition of divergence between developed and developing countries in the reasons for the wealth tax trends is important. In South America especially, 'on the ground' evasion looks more pronounced so the wealth tax mechanism is used to capture some revenue that is lost when income escapes income taxes of these countries. In contrast, developed countries appear to have experienced greater avoidance issues as taxpayers sought to minimise their tax burdens within the letter of the law. The additional greater difficulty for developing countries, as seen in South America, is identifying alternative revenue sources. Evidence suggests that most developed countries have tax systems with greater flexibility to preserve progressivity in selection of an alternative revenue source when they eliminate a wealth tax.

#### 4. CONCLUSIONS AND FUTURE POLICY DIRECTIONS

In light of the identified trends and practical issues, what is the future of net wealth and transfer taxation? As many economies recover from the global financial crisis, there are no certainties. However, two trends look likely to continue for developed countries.

The first trend is the continuing simplification in those countries that have existing net wealth or transfer taxes as part of their tax systems. Germany, Sweden and Norway are examples of countries that have undertaken simplification reforms in the past five years.<sup>91</sup> The Czech Republic has indicated that its current gradual gift and inheritance tax rates will be replaced by flat rates from 2015.<sup>92</sup> The pursuit of simplification was also highlighted by the Mirrlees Review prepared in the UK, which envisaged that countries would pursue simpler wealth tax models in the future.<sup>93</sup> If simplification is

<sup>87</sup> López, Ramón, 'Fiscal Policy in Chile: Promoting Fiscal Growth?' (2011, The University of Maryland Working Paper No. 11-01).

<sup>88</sup> Gómez Sabaini, Carlos, Juan and Juan Pablo Jiménez, 'Tax Structure and Tax Evasion in Latin America' (2012, United Nations Publication LC/L.3455).

<sup>89</sup> Bird, Richard M. 'The Taxation of Personal Wealth in International Perspective' (1991), 17 *Canadian Public Policy* 3, 324. See also Ernst & Young, *International Estate and Inheritance Tax Guide* (Ernst & Young Tax, 2012).

<sup>90</sup> Jenkins, Glenn P., 'Tax Changes before Tax Policies: Sri Lanka 1975-1988' in Malcolm Gillis (ed), *Tax Reform in Developing Countries* (Duke University Press, 1989) vol 1, ch 7, 237.

<sup>91</sup> Cowell, Frank A., 'Bequests, Taxation and the Distribution of Income and Wealth' (2012) 200 *Review of Public Economics* 1.

<sup>92</sup> Cowell, Frank A., 'Bequests, Taxation and the Distribution of Income and Wealth' (2012) 200 *Review of Public Economics* 1.

<sup>93</sup> Boadway, Robin, Chamberlain, Emma and Carl Emmerson, 'The Taxation of Wealth and Wealth Transfers', in Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, (Oxford University Press for Institute for Fiscal Studies, 2010).

pursued, some convergence may be anticipated. This is particularly the case in the European Union where several regulations and directives in other areas of tax policy and administration have sought to achieve consistency among its members.

The second trend is the expectation that countries will seek to identify and implement more efficient wealth taxes. This trend may see a continued decline in net wealth taxes, as has already been the case for several developed countries, as they appear to be the most problematic in operation.<sup>94</sup> Increasing concerns over capital mobility and tax competition are anticipated to support this trend, as the scope of existing net wealth taxes is limited. This is especially so in the light of evasion and avoidance in situations where assets are transferred beyond the jurisdictional borders.

In addition to these two broad trends in developed economies, some level of divergence with respect to developing and transitional countries is also expected to persist. Developing countries continue to face general revenue pressures and have found it more difficult to identify replacement tax revenue sources. Further, these countries have different political, social and economic priorities. Therefore, it is likely that they will more reticent in identifying a replacement tax since the success of any such replacement tax would be uncertain.

This article has explored wealth taxation across different jurisdictions. Most developed countries look to get along adequately without any great exposure to net wealth and/or transfer taxes. When developed countries eliminate such taxes, they reasonably readily identify replacement revenue sources via base broadening in other tax areas. Given the small yield of wealth taxes, no serious revenue or progressivity trade-offs are evident in developed countries.

Some developing countries have also followed developed countries in paying little heed to wealth taxes. Others, however, have diverged. This is particularly the case in respect of corporate net wealth taxes. These taxes play an important role in several South American countries, largely due to the inadequacy of the overall tax revenue collected by these countries. This significant divergence is expected to remain in the medium term.

Complexity, avoidance and evasion concerns have been identified as some of the main reasons behind the general trends. These issues are reflected in practical considerations across countries. Going forward, they are anticipated to be at the forefront of future tax policy direction, and to strongly militate against any more widespread adoption of wealth taxes, in any form, in the immediate future.

Nonetheless, wealth taxes – whether they are imposed on the holding, transfer or appreciation of wealth – will continue to feature in debates about the appropriate mix of taxes in contemporary society. It is unlikely that such taxes will ever be more than a minor part of that mix, and taxes on the holding of wealth may well continue to lose ground compared to other taxes and other times, even in the current uncertain economic climate that confronts many governments around the world. But wealth transfer taxes, particularly in the form of inheritance-type taxes on death, and wealth appreciation taxes, as epitomised by the CGT, will continue to play important roles in modern tax systems. At the very least they will continue to perform a role of political

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<sup>94</sup> Bach, Stefan, Beznoska Martin and Viktor Steiner, 'A Wealth Tax on the Rich to Bring down Public Debt? Revenue and Distributional Effects of a Capital Levy' (2011, German Institute for Economic Research Discussion Paper No. 1137).

signalling – letting those in society without wealth know that it is not just they that have to make all the sacrifices in times of financial hardship (when welfare provision is continually being curtailed).