THE CONSEQUENCES FOR INTERNATIONAL FISCAL LAW OF UNILATERAL ANTI-TAX HAVEN LEGISLATION

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PREFACE

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Richard Stuart Collier
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INTRODUCTION

This thesis is concerned with the consequences for international fiscal law, and the development of international fiscal law, of unilateral anti-tax haven legislation. For the purposes of the discussion, anti-tax haven legislation of the U.S. and the U.K. has been taken as examples of unilateral legislation directed against the use of tax havens. There are a number of differences between the statutory form of the U.S. and the U.K. legislation and these are reflected in the analysis of the two sets of measures.

The thesis is divided into four parts, A-D. Chapter one of Part A commences with a discussion of the nature of international fiscal law and of the policies, principles and objectives underlying international fiscal law. It is noted that a primary objective underlying international fiscal law, determined by reference to economic criteria, can be identified. This objective, the removal of fiscal distortions to the free movement of capital and persons and goods and services, in turn dictates policies and principles underlying international fiscal law which seek to implement or deliver this primary objective. These policies and principles represent the prescriptive tools which are used in the analysis of unilateral anti-tax haven legislation throughout this thesis. After this first chapter on international fiscal law, the following two chapters deal with the concepts of international tax avoidance and tax havens respectively. Both concepts are of considerable relevance to international fiscal law, and, more importantly here, to the assumptions on which unilateral anti-tax haven (CFC) legislation is based.

Parts B and C are each divided into two chapters which consider the official attitudes to international tax avoidance and tax havens and the background to, and development of, the CFC legislation of the U.S. (in Part B) and the U.K. (in Part C).

Part D represents the conclusion of this thesis and contains two chapters. The first is concerned with an evaluation of unilateral anti-tax haven legislation, according to the criteria of international fiscal law. The final chapter of Part D offers conclusions on the consequences for international fiscal law of the unilateral anti-tax haven legislation discussed in the main body of this thesis.

The law is stated as at 30 November 1988.

PART A

INTERNATIONAL FISCAL LAW, INTERNATIONAL TAX AVOIDANCE AND TAX HAVENS

CHAPTER 1

INTERNATIONAL FISCAL LAW

INTRODUCTION

This thesis is concerned with the consequences for international fiscal law (IFL) and particularly the development of IFL of unilateral anti-tax haven legislation. The initial task must be, therefore, to set out what is meant by the concept of IFL and how the consequences for IFL of unilateral anti-tax haven legislation are to be measured and appraised. This requires an analysis of the policies and objectives underlying IFL as well as an analysis of the principles which are used as working tools to implement those policies and objectives. This analysis in turn cannot be done without reference to the phenomenon of international double taxation, which is, as will be demonstrated, the main reason for the existence of IFL. It is also necessary to outline the nature and effect of double taxation agreements (including model double taxation agreements) since such agreements have proved the primary means of developing IFL. Accordingly, all the above subjects are discussed in this chapter, which concludes with an analysis of the current status of the principles underlying IFL and an explanation of why the field of IFL is of major importance in its own right.

Before proceeding to an analysis of the concepts referred to above, it is necessary to state the reason that this thesis is concerned with unilateral anti-tax haven legislation and how this legislation is dealt with in the discussion that follows.

The larger topic underlying the discussion in this thesis is the appraisal of the implications of the general policy issues which determine the development of IFL for the enactment (on a unilateral basis) of anti-avoidance legislation directed at cross border structures or transactions. This potentially vast topic is reduced to manageable proportions for the purposes of this thesis by selecting unilateral anti-tax haven legislation as an example of such unilateral anti-avoidance legislation. The U.S. and U.K. unilateral anti-tax haven legislation have in turn been selected (again, for reasons of containing the analysis and discussion within manageable limits) as representative of such unilateral anti-tax haven legislation. There are various reasons for selecting the U.S. and U.K. legislation. First, the U.S. and

U.K. legislation is each representative of the two main types of unilateral anti-tax haven legislation, namely legislation directed at certain specified types of income (U.S. legislation) and legislation directed, in effect, at certain types of company (U.K. legislation). Second, the U.S. legislation has been in existence since 1962 and therefore an analysis of that legislation provides an opportunity for a review of the development of such unilateral anti-tax haven legislation over a comparatively lengthy period. By contrast, the U.K. legislation has been enacted much more recently, in 1984, following a lengthy consultation process, and therefore provides an opportunity for a close review of that enactment process. Thus, although the review, analysis and conclusions contained in this thesis are based on the unilateral anti-tax haven legislation of the U.S. and the U.K., it is considered that the above factors facilitate the wider extrapolation of conclusions which are of relevance to unilateral anti-avoidance legislation more generally, although it should be emphasised that this wider extrapolation is by no means crucial to the arguments contained in this thesis. A third reason for the choice of the U.S. and U.K. legislation is that, in the course of preparing this thesis the writer has been based in both London and New York, and this has provided additional opportunities for researching the U.S. and U.K. legislation at a technical level and also through discussions with tax officials and tax practitioners.

Finally, it should be noted that although this thesis is concerned with legislation directed against tax havens, the concept of "tax havens" is itself somewhat problematic and this point is taken up specifically in Chapter Three.

THE NATURE OF INTERNATIONAL FISCAL LAW

The following discussion is intended to clarify the nature of IFL and its relationship with the principles or objectives which underlie it. This relationship is not a simple one and on close scrutiny it is apparent that there is a hierarchy of objectives, policies, principles and enactments of IFL which can be summarised in diagrammatic form as follows:-[1]

The primary objective underlying IFL: the removal of fiscal distortions to the free movement of capital and persons and the exchange of goods and services.

↓

The policies underlying IFL (e.g. equity and neutrality).

↓

The principles or working concepts underlying IFL which are designed to implement the overall objective of IFL.

↓

Pre-substantive patterns relating to IFL (e.g. unilateral model double taxation conventions).

↓

Substantive enactments which constitute IFL (e.g. specific bilateral double tax treaties, specific unilateral tax provisions - including anti-tax haven legislation etc).

The nature of the primary objective underlying IFL, and the policies, principles and enactments of IFL will be discussed separately below. It may, however, be useful to summarise the overall relationship between all these elements.

As will be explained below, the objective of IFL - the removal of fiscal distortions to the free movement of capital, persons and the exchange of goods and services - determines the policies of IFL - such as equity and neutrality - which are intended to ensure that the primary objective underlying IFL is secured. These "policies" might equally be characterised as sub-objectives of IFL or even as normative requirements of IFL. Although the labelling is therefore open to debate, the <u>function</u> of these policies or sub-objectives is relatively clear. The function is, as noted above, to ensure the primary objective underlying IFL is secured. Thus, referring to the two main "policies" of IFL - equity and neutrality - it is considered that fiscal distortions to the free movement of capital, persons and the exchange of goods and services can best be removed (or at least reduced) by following general fiscal policies which encompass fairness (or equity) to the

total body of taxpayers and fairness between states and also neutrality in the sense that the impact of taxes is kept as neutral as possible (i.e. fiscal distortions to market behaviour is minimised).

The above policies in turn facilitate the creation of principles or "working tools" which are designed to shape concrete enactments of IFL. For example, these principles include the residence principle, the permanent establishment or genuine connection principle, the arm's length doctrine, etc.

These principles are most commonly understood by tax practitioners because of their operation in comprehensive double tax treaties. The form of such treaties is significantly determined by certain model bilateral double taxation conventions.[2] Such model conventions provide a model draft on which specific double tax treaties, entered into between states, can be based. The model treaties are not therefore specific enactments of IFL in themselves but they are of enormous significance in influencing the form in which such specific enactments are enacted. It is for this reason that such model treaties are referred to separately in the above hierarchy as "pre-substantive patterns relating to IFL".

The final category referred to in the above hierarchy is that of the substantive enactments which constitute IFL. This category includes specific bilateral double tax treaties and specific unilateral tax provisions (which includes the type of legislation which is discussed throughout this thesis). The various different categories referred to above and their inter-relationships are discussed in further detail below.

Before proceeding to that discussion it is necessary to mention briefly the status of the existing "mainstream" discussions relating to IFL.

The concept of IFL (including the objectives, policies and principles of IFL) is not a familiar concept to most tax practitioners and discussion of IFL has remained predominantly an academic pursuit. In practice, domestic tax specialists who

encounter the topic will often assert that to talk of "international" taxation or "international fiscal law" makes no sense since taxation, by its very nature, can be levied by a state on a domestic basis only. As a result, the debate over IFL has in the past concentrated on whether there are any substantive tax rules attaching to the concept of IFL or whether IFL merely describes the processes by which domestic taxation is allowed or not allowed to operate in situations where two or more states claim taxing rights in respect of the same international transaction. In short, the debate has addressed the status of the rules of IFL, i.e. the question of whether the "rules" of IFL are merely a set of rules about conflict law or whether they are substantive rules of tax law.[3] Discussions on the status of the rules of IFL have also concentrated on whether there are limits under international law to the fiscal jurisdiction of a state.[4]

The status and nature of the "rules" of IFL are discussed later in this chapter. However, it is submitted that this "mainstream" debate has typically failed to place the rules or specific enactment of IFL in their context as a function of the primary objective and the policies underlying IFL. As will be demonstrated below, this seems to be because the primary objective and policies underlying IFL are so well-understood as not to require express clarification and are therefore taken as read. A discussion and a clarification of the primary objective and the key policies underlying IFL are, however, required as the preliminary step in this thesis because these matters are of fundamental important to this thesis. This is because the central part of the appraisal of unilateral anti-tax haven will be focused on the consequences for IFL - and particularly for the principles, policies and the primary objective underlying IFL - of such unilateral anti-avoidance legislation. It is therefore to these latter matters that the discussion will now turn.

THE PRIMARY OBJECTIVE UNDERLYING IFL

As has been stated above, the primary objective underlying IFL is the removal of fiscal distortions to the free movement of capital and persons and the exchange of goods and services. The "fiscal distortions" which have been identified as being of primary relevance in this context are those arising from the phenomenon of international double taxation. This perspective has become so widely-accepted as hardly to require explanation:

> "The phenomenon of international juridical double taxation, which can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods, and its harmful effects on the exchange of goods and services and movements of capital and person, are so well known that it is superfluous to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between OECD Member countries."[5]

A similar view is expressed by the UN Department of International Economic and Social Affairs:

> "The growth of investment flows from developed to developing countries depends to a large extent on what has been referred to as the international investment climate. The prevention or elimination of international double taxation - i.e., the imposition of similar taxes in two or more States on the same taxpayer in respect of the same base - whose effects are harmful to the exchange of goods and services and to the movement of capital and persons, constitutes a significant component of such a climate. Broadly, the general objectives of bilateral tax conventions may today be seen to include the full protection of tax payers against double taxation (whether

direct or indirect) and the prevention of the discouragement which taxation may provide for the free flow of international trade and investment.."[6]

A more detailed explanation of this primary objective underlying IFL is given by Arnold Knechtle in his work entitled "Basic Problems in International Fiscal Law".[7] Knechtle surveys the increasing interdependence of trading areas and the consequential increasing importance of IFL which regulates the fiscal treatment of transnational affairs. Knechtle then considers the various factors behind this increasing interdependence (including dynamic technological progress, the widespread adoption by states of a liberal foreign economic policy - at least in the transatlantic area - and the quest for European unification[8] before concluding:

> "As a result of this worldwide liberalization and the creation of larger trading areas, *economic development has accelerated*, and *international competition has intensified*. Enterprises are forced to adapt their size and structure to the changed market dimensions, if they are to remain competitive. This restructuring encourages the rise of *multinational enterprises*; greater mobility and more flexible management methods enable these corporations to make an increasing number of investment decisions unencumbered by competition-distorting national influences. In order to follow the economic principle as closely as possible, such enterprises consistently apply the principle of the international division of labour by freely exploiting the advantages of location which the various States can offer as regards political stability, civil law, fiscal law, transport and production facilities, etc. As a result, considerable advantages are obtained and rationalization and greater ability to weather economic depressions..... All these efforts in the field of economic integration have led to considerable success. Nevertheless, freedom of movement in international business is only partly assured; what has been achieved largely

> amounts to an abolition of the classical trade restrictions (tariff protection) and of payment restrictions. After these primary obstacles are removed, the remaining restrictions weigh all the more heavily."[9]

Knechtle divides the "remaining restrictions" to which he refers into fiscal and non-fiscal barriers to the freedom of movement of capital, persons, goods and services.

The non-fiscal barriers include non-tariff protection (such as trade and health regulations, industrial standards, state procurement practices, administrative procedures, etc) and foreign investment risks (which Knechtle categorizes as (a) political risks, such as wars, revolutions or nationalisation, (b) legal risks that arise from a national legislation and jurisdiction that are insufficiently developed and (c) currency and transfer risks, including such events as devaluation, transfer restriction and moratoria).[10]

This fiscal barriers are divided into two categories. First, there are the differences in the fiscal burden as competition and location factors. Second, there is the phenomenon of multiple taxation. By the first category, Knechtle refers to the differences in the structure of the national tax systems and in the rates of tax which can have an effect on prices and thus distort competition with the result that competitive advantages or disadvantages due to fiscal measures may arise:

> "The influence which fiscal measures have on competition has thus been revealed, and they have become a *decisive element in business calculations.* The reason for this is clear: so long as competition can be influenced by structural differences in the national tax systems, every transnational investment plan and business plan must, in order to be

> successful, take the effect of taxation into account as a cost factor in international competition."[11]

Commenting on the phenomenon of multiple taxation, Knechtle states:-

> "*Multiple taxation of transnational activity* is the most serious danger. The ever increasing economic interdependence of States - although it is to be welcomed - has added to this risk and has led to a considerable rise in the number of international tax cases.....the consequences of multiple taxation are so detrimental that it is in the interest of all national economies to avoid it as far as possible."[12]

The concern over double taxation is not a recent development. Early measures to prevent double taxation can be traced back to at least 1819 and it is notable that all these early measures - in the Netherlands, and the U.K. - appear to be premised upon the proposition that the avoidance of double taxation is a pre-requisite for the promotion of international trade.[13]

Much of the major early work on this subject was carried out by the League of Nations in the 1920s. The work of the League of Nations on the prevention of double taxation was begun as early as 1921 when its Financial Committee, acting on a recommendation of the International Financial Conference held the previous year in Brussels, entrusted the theoretical study of double taxation to four economists.[14] This was followed in 1922 by further work on double taxation (and tax evasion) which was carried out by certain "technical experts", a group of tax officials of the tax administrations of seven European countries.[15] After five sessions, from 1922 to 1925, the technical experts issued a report and resolutions dated 7 February 1925.[16] This work ultimately led to the formation of a Fiscal Committee of the League of Nations and to the preparation of bilateral model double taxation treaties for the prevention of double taxation[17] (these model treaties are discussed later in this chapter).

Since that work in the early 1920s, the concept of international double taxation has been widely recognised and discussed. There is no universally accepted definition of what is meant by the term "international double taxation". However, the characteristics of international double taxation are described in the introductory remarks of the O.E.C.D. Model Double Taxation Convention on Income and Capital:

> "The phenomenon of international double taxation .....can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods".[18]

Clearly, the possibility of international double taxation can only arise when a transaction or other form of business activity falls within the tax jurisdiction of more than one state. For example, a U.K. company opening a U.S. branch will find that the profits of the branch will be subject to tax in the U.S. and also in the U.K. Unless there is some form of relief in either tax system or in a tax treaty between the two countries, the profits of the branch will be taxed twice. The example illustrates the essence of international double taxation, namely that a transaction involving two or more states is more highly taxed than it would have been if it were a purely domestic transaction taking place entirely within the territory of any one of the states involved.

For an international enterprise, double taxation results in a heavier tax burden and also a loss of competitiveness, especially as compared to business rivals which operate exclusively within the borders of a single state. Given the growing interrelation and interdependence of the economies of individual states, international double taxation is an unwelcome and major impediment to the free movement of capital, persons, goods and services. It is for this reason that international double taxation has been regarded as the most pressing of international concerns in the area of IFL and has therefore been the subject to such attention for over seven decades.

However, in practice such international concerns can be ignored by states which are constantly eager to extend their claims to taxing rights. In the words of W. Ritter, General Reporter of the 1975 IFA Congress in London;

> "In practice there is a constant struggle between states as regards initial access to tax sources. And the struggle does not take the form of a dialogue designed to achieve an equitable balance, but rather the form of a one-sided and total exploitation of the sources of taxation at their disposal. Regardless of whether states proceed in such cases on the basis of residence or of territoriality, or of both, they will always seek to secure their share of tax revenue and will often take more than other states are prepared to concede".[19]

Juridical and Economic Double Taxation

The conventional view of international double taxation is that it occurs in one of two forms; juridical (or legal) international double taxation and economic international double taxation. The former limits itself to cases where the taxpayers are legally identical. The latter refers to cases where the same income or capital is taxed twice in the hands of taxpayers who are, legally, separate entities although, from an economic point of view, they are identical or closely associated. Economic international double taxation is also referred to as wider international double taxation or indirect international double taxation. In short, there is economic double taxation when the same income or capital is taxed twice but in the hands of different persons and there is juridical double taxation when the same income or capital is taxed twice in the hands of the same person. It is generally agreed that both types of international double taxation are equally harmful to international trade and business and should be avoided. However, efforts to prevent international double taxation have concentrated on juridical, rather than economic, international double taxation.[20]

The Causes of international double taxation

All cases of international double taxation have a common cause, namely that two or more states claim the right to tax the same transaction of a multinational enterprise. Such conflicting claims of the right to tax arise for the following reasons:

1. States claim fiscal jurisdiction according to different bases. For example, state A claims its right to tax because the transaction takes place within its territory (the "source" basis) while state B exercises its taxing rights because the relevant taxpayer is a resident of country B (the "residence" basis). Here international double taxation arises due to the lack of a single internationally accepted rule on the correct basis of jurisdiction.
2. Alternatively, countries may adopt the same basis of taxation yet differ in their definition of that basis. For example, two states might each claim that the same taxpayer is a resident of theirs or that the same transaction takes place within their territory. Here international double taxation arises due to a lack of universally-accepted definitions.
3. A third cause of international double taxation arises where one state adjusts the profits of one member company of an international group without a corresponding adjustment being made to the profits of the associated enterprise. This cause of international double taxation has become increasingly significant following the widespread interest shown by tax authorities in the intra-group transfer pricing practices of large multinational corporations. Problems of international double taxation arise either when there is no mechanism available for the corresponding adjustment or because the states involved cannot agree a corresponding adjustment. Since most double taxation treaties now include an article on procedure for mutual agreement, this problem should be chiefly confined to cases where no tax treaty has been concluded between the states involved. Unfortunately, the treaty mutual agreement procedure does not require the states to reach agreement and, in practice, there are a number

> of cases where one state refuses to act to avoid double taxation in the context of a mutual agreement procedure. Further, as is well known, significant delays can arise under the procedure with the effect that, in practice, it represents little more than a "last ditch" remedy to the taxpayer.

The above three causes of international double taxation deal with conflicts involved in direct taxation. international double taxation may also arise by means of indirect taxes. However, cases of indirect taxes causing international double taxation are significantly rarer. Knechtle[21] suggests the reasons for this are that indirect taxes are by their very nature territorially confined and the risk of international double taxation is diminishing owing to the trend towards value-added tax which may be payable only on imports but not on exports. For these reasons, there are virtually no general agreements between states governing indirect taxes, presumably on the ground that they are not necessary to prevent international double taxation.

From the taxpayer's viewpoint, international double taxation results in a higher overall tax burden which in turn affects the ability of an international enterprise to compete with firms which operate on a purely domestic basis. Inevitably, this distorts international entrepreneurial activity. Since this may lead ultimately to a loss of potentially taxable profits, there is in some situations an immediate and direct economic incentive to tax authorities to mitigate the effects of international double taxation. For example, the U.S. Congress introduced a foreign tax credit mechanism as part of the Revenue Act of 1918.[22] The basis of this was not merely to provide a "just" system but also "a very wise one", without which:

> "We would discourage men from going out after commerce or business in different countries or residing for such purposes in different countries if we continue to maintain this double taxation"[23]

The source of funding for such activity is also affected by the imposition of international double taxation as potential investors perceive that the net return on

investments fails to compensate for the greater risks inherent in such international activity.

From the macro-economic perspective, international double taxation acts against the international objectives of freedom of movement of capital and inhibits international trade. As such, it results globally in a less efficient use of available economic resources.

International double taxation can in theory be countered by unilateral, bilateral or multilateral measures. However, it has been mainly bilateral arrangements, contained in comprehensive double taxation conventions, that have been used to reduce the incidence of such double taxation. These conventions or treaties are discussed later in this chapter.

Although the removal (or, at least, reduction) of international double taxation has been the primary objective underlying the development of IFL, it has not been the only objective. In recent years particularly measures of IFL have been used as a means of combatting international tax avoidance and evasion and as a means of assisting by fiscal means developing countries.[24] These other uses of provisions of IFL are discussed later in this chapter in the context of double tax treaties. However, it is necessary to discuss in a little more detail the relationship of the primary objective underlying IFL to the objective of combatting tax avoidance and evasion.

Although the earliest work of the League of Nations was concerned exclusively with the problem of international double taxation,[25] it was not long before the subject of tax evasion was added to the agenda.[26] By "tax evasion" was meant the non-payment of tax which is legally due, for example as a result of the taxpayers deliberate concealment of negligence.[27] The early discussion of tax evasion makes it clear that this is by no means synonymous with the exportation of capital:

> "It may, perhaps, be useful to preface the following consideration by dispelling a misunderstanding and defining the scope of the questions relating to tax evasion, a subject which public opinion often confuses with the exportation of capital. Capital is exported abroad for many reasons. Some investors think that the rate of interest abroad is more attractive or suppose that their capital will be better managed abroad; some seek to protect themselves against risks of ultimate expropriation and yield to fears of a political nature; others desire in general to minimise their risks by dividing up their wealth in a number of different countries. Finally - and there have been many and striking instances of this fact in recent years - national of a country whose budget shows a deficit, and whose issues of paper money become more and more numerous fear above all the definite depreciation of their currency, which in that case is the cause of the export of capital abroad and its failure to return to the owner's own country. In this flight of capital due to these various reasons, considerations of taxation play only a secondary part."[28]

A number of significant points emerge from these early discussions of tax evasion. Most important in the present context was the acceptance that the problem of tax evasion is of secondary importance to that of double taxation and that, by removing double taxation (primarily through double tax treaties), progress could be made in combatting tax evasion:

> "The Assembly resolution envisaged the prevention of fiscal evasion as a subject apart from that of double taxation, but it is significant that clauses for various types of assistance have generally been inserted only in treaties for the prevention of double taxation, or in supplementary Conventions. In short, the consensus of opinion seems to be that States are unwilling to help each other to ensure

> their respective tax laws unless they first agree to remove the inequitable burden that results from double taxation."[29]

Second, it is clear from the early discussion (and particularly the quotation on the exportation of capital referred to above) that the commercial use and exportation of capital overseas was viewed as largely a commercial and not a tax matter.

Third, it was agreed that tax evasion could best be combatted by the use of double tax treaties, containing, for example, exchange of information provisions.

These points are important because they provide historical confirmation of the status of efforts to combat tax evasion, namely as an objective of secondary importance compared to the primary objective of removing fiscal distortions by removing the phenomenon of international double taxation.

It is submitted that it is therefore not correct to view efforts or measures against tax avoidance and evasion as representing a self-contained and independent objective of equal importance to what is referred to in this thesis as the primary objective underlying IFL. Indeed, it is arguable that early attempts to prevent tax evasion were directly attributable to the recognition of this primary objective: the idea being that the prevention of tax evasion is required to achieve the policy of fiscal equity and this must in turn be achieved in order to remove the fiscal distortions which would otherwise effect the free movement of capital and persons, goods and services. This interpretation seems to have been recognised in the detailed comments made by the Technical Experts' report:

> "Essentially, however, the connection between the two problems is much more a moral than a material one; the idea of justice in the distribution of taxes is the predominating consideration in all the investigations which we have conducted, both in regard to double taxation and evasion. The International Chamber of Commerce, which had, of course, only to investigate the first problem and which

represents a large body of taxpayers throughout the world, clearly perceived this close dependence, and a delegation from that body in April 1924 informed us, throughout its spokesman, M. Clémentel, that "business men, who are a very worthy class, will welcome any careful considered and equitable measures which the experts may think it desirable to propose for the prevention of tax evasion."[30]

THE POLICIES UNDERLYING IFL

What are referred to in this thesis as the policies underlying IFL were discussed in one form over two hundred years ago by Adam Smith in "The Wealth of Nations".[31] Adam Smith set out four "maxims" with regard to taxes in general and these maxims are equally applicable to international tax law as to domestic tax law. These maxims or canons of taxation were intended to be criteria by which particular taxes or tax systems may be judged. The criteria may be summarised as follows:[32]

- **equity:** this requires fairness as between the body of tax payers. Theories of public finance now generally distinguish between vertical and horizontal equity. Horizontal equity requires that those in equal circumstances should pay an equal amount of tax and vertical equity means those in unequal circumstances should pay different amounts of tax.[33]

- **neutrality:** this requires that the incidence of taxation should not distort the market. A neutral tax system is therefore one which is designed to minimize as far as possible the impact of the tax structure on the economic behaviour of agents in the economy.[34]

- **certainty:** This is explained by Adam Smith as follows:

  "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person..... The uncertainly of taxation encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty."

  Certainty therefore requires that there is a clear scope to any particular tax and that the tax can be and will be enforced.

- **administrative efficiency:** this requires the ease of collection of tax and that the costs of collection are acceptable given the yield.

The above maxims are still recognisable in the criteria used by economists in appraising tax systems[35] although various other factors may now also be considered.[36]

The above maxims of taxation were discussed by Adam Smith over two hundred years ago (the book first appeared in the Spring of 1776) and therefore clearly precede the discussions of international double taxation which have been conducted from the 1920s to date.[37] However, these maxims or criteria (which are in this section labelled "policies") - and particularly those of equity and neutrality -

are of fundamental importance to IFL and the primary objective of IFL. This was recognised by the first report on double taxation commissioned under the auspices of The League of Nations - The 1923 Report on Double Taxation by four eminent economists.[38] The very first question considered in that report relates to the economic consequences of double taxation from the perspective of "the equitable distribution of burdens" and "interference with economic intercourse and with the free flow of capital".[39]

The discussion in Knechtle's "Basic Problems in International Fiscal Law"[40] also emphasises the importance of equity and neutrality which, for Knechtle, are the only two general objectives of IFL and which also determine the other special objectives of IFL. The special objectives Knechtle refers to are, first, the elimination or mitigation of international double taxation; second, the elimination of discrimination against foreign taxpayers; third the encouragement of investment in developing States; and, fourth, the prevention of "tax flight" (a generic term used by Knechtle to refer to tax avoidance in various forms).[41]

Knechtle does not seem <u>expressly</u> to recognise what is referred to in this thesis as the primary objective underlying IFL as such. Instead, he postulates that the general aim for IFL is to pave the way for equitable taxation of international economic affairs and, building on a view of what equitable taxation means, asserts that:

> "Once the postulate of fiscal justice has been achieved, distortions of competition due to taxation disappear"[42]

Thus, for Knechtle, equitable taxation is the pre-eminent objective which, when realised, will assist in achieving neutrality of taxation in transnational economic activity. Knechtle's arguments proceed as follows:

> ""Neutrality" of taxation in regard to international competition in turn ensures the achievement of the second main aim of IFL: the

> maintenance and furtherance of freedom of movement in international business in the sphere of taxation."[43]

Knechtle's views contain the same elements as reflected above in the discussion of the primary objective underlying IFL and the policies of IFL but his hierarchy is different. For Knechtle, equity, the main general aim of IFL, is logically prior to neutrality which in turn delivers the second aim of IFL which is effectively the removal of fiscal distortions to the free movement of capital and persons and the exchange of goods and services. It is considered by the author that the weakness in Knechtle's perspective is that it is presumed upon the requirement for fiscal equity.[44] For Knechtle, therefore, a normative view of fiscal equity is the starting point of discussions on the objectives and role of IFL.

It is submitted, however, that the proper starting point for discussions on IFL must be the need to remove or minimise fiscal distortions to the free movement of capital, persons, goods and services; i.e. what is referred to above as the primary objective underlying IFL. The fact that this is the proper starting point of - or the primary objective underlying - IFL is attributable to the immense significance - in economic terms - of foreign trade. David Ricardo in "The Principles of Political Economy and Taxation"[45] develops the analysis in a chapter "On Foreign Trade":[46]

> "It is quite as important to the happiness of mankind that our enjoyments should be increased by the better distribution of labour, by each country producing those commodities for which by its situation, its climate, and its other natural or artificial advantages it is adapted, and by their exchanging them for the commodities of other countries, as that they should be augmented by a rise in the rate of profits.....Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each. This pursuit of individual advantage is admirably connected with the universal good

> of the whole. By stimulating industry, by rewarding ingenuity, and by using most efficaciously the peculiar powers bestowed by nature, it distributes labour most effectively and most economically: while, by increasing the general mass of productions, it diffuses general benefit, and binds together, by one common tie of interest and intercourse, the universal society of nations throughout the civilised world."[47]

Ricardo's argument - now an accepted tenet of economic theory - is therefore that foreign trade is connected with "the universal good of the whole" because it improves the economic lot of all participants. Anything interfering with this process of foreign trade (or the free movement of capital, persons, goods and services) is, on economic grounds, therefore to be avoided assiduously, a fact which is now clearly recognised. An examination of Ricardo's proof for this conclusion - the Law of Association, better known under the name of law of comparative cost - is beyond the scope of this thesis[48] and it must suffice to refer to certain comments on the work of Ricardo in this area which were made by one of the most influential of twentieth century economists, Ludwig Von Mises:

> "The law of association makes us comprehend the tendencies which result in the progressive intensification of human cooperation. We conceive what incentive induced people not to consider themselves simply as rivals in a struggle for the appropriation of the limited supply of means of subsistence made available by nature. We realize what has impelled them and permanently impels them to consort with one another for the sake of cooperation. Every step forward on the way to a more developed mode of the division of labor serves the interests of all participants. In order to comprehend why man did not remain solitary, searching like the animals for food and shelter for himself only and at most also for his consort and his helpless infants, we do not need to have recourse to a miraculous interference of the Deity or to the empty

> hypostasis of an innate urge toward association. Neither are we forced to assume that the isolated individuals or primitive hordes one day pledged themselves by a contract to establish social bonds. The factor that brought about primitive society and daily works towards its progressive intensification is human action that is animated by the insight into the higher productivity of labor achieved under the division of labor."[49]

The relevant background of economic theory explains why international double taxation has been the subject of such attention by international organisations[50] and it is equally for this reason that the primary objective underlying IFL is the removal of fiscal distortions to the free movement of capital, persons, goods and services.

This objective is assisted by the policies underlying IFL, and particularly those of equity and neutrality. These concepts have already been referred to above but require further comment.

The criteria of fiscal equity have been described as universality and equality of taxation[51] but in the international sphere it is clearly unrealistic to think that this must entail that taxpayers in all States should bear the same tax burden in similar economic circumstances. Instead, the requirement of fiscal equity is to be interpreted as requiring fairness between the body of taxpayers in any given State. In the context of IFL, the concept is therefore interpreted in a manner which is similar to the original statement of it by Adam Smith.

An example of the equity policy may assist in clarifying its relationship to the primary objective underlying IFL and to the principles underlying IFL and IFL itself.

One of the manifestations of the equity policy is the non-discrimination principle and thus ultimately the non-discrimination article that appears in most double

taxation treaties[52] and which is designed to prevent one treaty country from imposing discriminatory taxation on taxpayers of the other.

Even in its most concrete form as an article in a specific double tax treaty, the provision on non-discrimination is of direct relevance to the primary objective underlying IFL since it acts to prevent one form of fiscal distortion, namely the distortion that would otherwise arise from such discriminatory taxation being levied.

The distortion of market behaviour is similarly minimised by adherence to the neutrality policy:

> "It may be stated as a basis for comment that double tax relief, if it is effective and genuinely has tax relief of the taxpayer as its objective, should achieve the situation where the taxpayer pays no more tax operating cross-border than it would if operating in one state alone. In other words, the system should be neutral to the decision to operate cross-border."[53]

It has been argued that neutrality is impossible:

> "The essential point is that the object of many economists" quest, a neutral tax, i.e. a tax that will leave the market exactly the same as it was without taxation, must always be a chimera. No tax can be truly neutral; every one will cause distortion".[54]

It is certainly correct to say that no tax will leave the market undisturbed and in this sense no tax can ever achieve neutrality. However, a state can attempt to reduce the distorting effects of taxation within its territory by imposing standard rates of taxation on all similar activities and by phasing out existing fiscal privileges. These options are clearly not available in an international context.

The huge differences across the globe in the tax burdens imposed by individual states guarantee a significant distorting effect by taxation on the world economy.

Given that international agreement on the basis and quantum of taxation is as remote as ever and given that a large number of states, including many low-tax states, have not so far made a major contribution to the development of IFL, it is very unlikely that progress can be made in achieving any sort of international tax neutrality in the sense of imposing globally standard rates of tax, etc. Moreover, it is not necessarily desirable for such a development to take place. The level and basis of taxation is a matter for each state to determine in the exercise of its own fiscal autonomy.

States take radically different views as to the function of taxation and there are considerable differences in the reliance placed upon tax revenues from one state to another. Indeed, there are often major policy shifts in respect of taxation within a single state.[55]

Therefore, as a result of the fact that, judged in economic terms, taxation is certain to be non-neutral in its effect and the fact that levels of taxation will vary from one state to another, the goal of neutrality assumes in the context of the development of IFL a more realistic objective than that of global taxation on a uniform basis. This more realistic objective is the removal of international double taxation. The development of IFL over recent decades has already been responsible for the significant progress made towards eradicating such international double taxation and since such double taxation has a significant distorting effect on international trade and it is one of the early achievements of IFL to have addressed and partly resolved this problem.

Thus, the "neutrality" achieved by the removal of international double taxation is the removal of any extra tax burden as a result of a transaction being an international transaction rather than a domestic one. In general, taxation will continue to be a distorting factor in, for example, the choice between locating a

new manufacturing subsidiary in either a high tax state or a low tax state. However, the removal of international double taxation will at least attempt to ensure that international transactions are taxed no more heavily than comparable domestic transactions.

As noted earlier, in recent years states have sought to achieve two additional objectives, both of which are relevant to the policies underlying IFL. A strong lobby from the world's developing countries has argued that IFL should be used to secure investment by fiscal means in their countries. This goal is reflected, for example, in the United Nations Model Double Taxation Convention[56] with its emphasis on higher withholding taxes on operations in developing countries.

Secondly, there is an is increasing concern on the part of states with the issues of tax avoidance and evasion. To some extent this concern can be seen as an aspect of the two major policies underlying IFL, the achievement of equity and neutrality, since it is frequently argued that these policies cannot be implemented where avoidance and evasion of taxes is possible. In recent years, however, the increased attention to this phenomenon of "tax flight" can only be explained by the fact that many states now see the development of IFL as an additional means of enforcing their taxation jurisdiction and thereby maximising their income from taxation.

These recent tendencies in IFL to assist developing countries and to prevent tax flight present a potential clash with the primary policies of IFL, equity and neutrality. The use of IFL to assist developing countries by fiscal means is hardly reconcilable with the objective of fiscal neutrality, although may be justified on one view of equity (vertical equity). Moreover, if, in an attempt to curtail tax avoidance and evasion, states concentrate on using IFL to this end, then significant progress towards achieving the primary policies of IFL is unlikely to be made.

The remaining two of the criteria referred to by Adam Smith - certainty and administrative efficiency (or "workability") - are obviously as valid for measures of

IFL as they are for domestic law. They are self-evident criteria and require no further explanation at this stage, although are discussed later in this thesis in the discussion of the CFC legislation.

THE PRINCIPLES UNDERLYING IFL

The principles underlying IFL represent widely-agreed working tools or concepts which can be used in a practical way to promote the objective underlying IFL, consistent with the policies which have been discussed in the previous section.

These internationally-accepted principles of fiscal equity have been developed over the last six and a half decades[57] and apply in respect of both corporate and non-corporate taxpayers but are considered here only insofar as they relate to corporate taxpayers. Such principles have significantly determined the provisions of international tax treaties between states and continue to be debated by international institutions, academics and other commentators. Most of these principles were initially developed by the Technical Experts Committee of the League of Nations, which, for example worked on concepts of fiscal domicile or residence and definitions of permanent establishment in the 1920s.[58] There are countless examples of references to the principles of IFL in this sense. The O.E.C.D., for instance has spoken of:

> "the generally accepted principles of double taxation conventions that an enterprise of one state shall not be taxed in the other state unless it carries on business in that other state through a permanent establishment situated therein"[59]

The principles referred to above are of particular importance because they establish the nexus that is required to exist before one state may tax a company which is a resident of another. That nexus is "taxable presence" which has also become known as the "permanent establishment" concept as a result of its expression in both the O.E.C.D. and U.N. model double taxation conventions.[60]

Under this principle, tax may be levied by a state on non-resident companies on the profits generated by that company within its jurisdiction. For example, this principle will normally apply to tax the profits of a branch of an overseas company. It is generally accepted that tax is so levied only if activity of a non-resident is such that it generates (or could generate) profits. Thus, a representative office which generates no profits would not amount to a taxable presence (i.e. it would not qualify as a permanent establishment). Equally, there is general acceptance that where jurisdiction to tax arises as a result of there being a permanent establishment, the profits subject to tax shall be those attributable to that permanent establishment.

These principles are of fundamental significance to IFL because they effectively arbitrate between the competing claims of the relevant fiscs. In so doing, they remove, or at least reduce, the likelihood of double taxation arising as a result of the separate application by different states of varying principles of taxation.

Other principles underlying IFL are no less important. An almost universally accepted approach to dealing with transactions carried out between associated companies which do not transact using arm's length prices is an application of the transfer pricing principles.

In connection with this, the United Nations has observed:

> "The most common approach taken by tax authorities dealing with artificial transfer pricing is to seek to assess the profits arising from international transactions between affiliated enterprises on the basis of the "arm's length" principle. There is general acceptance of this principle which is incorporated in the O.E.C.D. Model Double Taxation Convention, the United Nations Model Double Taxation Convention between Developed and Developing Countries and most bilateral treaties for the avoidance of double taxation"[61]

The recognition and acceptance of the principles underlying IFL may in fact prevent tax authorities from promulgating domestic legislation which would potentially cause difficulties to the operation of those principles.[62] This yielding to principles underlying IFL is significant given a state's unfettered ability to impose its own taxation measures on those within its jurisdiction. The point can be illustrated by reference to the attempts by various tax authorities to introduce or impose rules to tax "global trading" securities operations. The Senior Attorney in the IRS charged with this task in the U.S. has commented:

> "In implementing a solution to the tax issues raised by global trading, unilateral approaches are severely constraining. Given the variety of trading arrangements and the need for acceptance by foreign jurisdictions, writing meaningful regulations on this topic is virtually impossible. Instead, bilateral and multilateral solutions are greatly preferable"[63]

The "need for acceptance by foreign jurisdictions" requires that any taxation measures affecting international businesses conform to certain basic standards of equity - in this case such measures would need to conform fairly with the arm's length principle.

Similar references to what are the fundamental principles underlying IFL are also common amongst commentators. For example, there is the comment of Dr. B. Runge that "Administrative assistance should not lead to taxation over and above the recognised principles of international tax law".[64]

The "recognised principles of international tax law", in so far as they relate to corporations, suggest, broadly, that a fisc is entitled to tax companies which are resident in its jurisdiction and also to tax non resident companies to the extent such companies have a taxable presence or permanent establishment within its jurisdiction. (The taxation of non-resident companies has already been dealt with above in the discussion of "taxable presence".)

With regard to resident companies, some (but not all) states tax companies resident within their jurisdiction on their world-wide income. The U.S. and the U.K. are examples of this approach, (although it should be noted that there is no universally accepted test of the residence of a company[65]). The major alternative to this approach is some form of territorial basis whereby taxation is levied by a state only on income arising within its territory. This is achieved either by a basis of tax which seeks to tax only income arising within the territory (and Hong Kong is perhaps the most well known state using this basis[66]) or by a state which brings all worldwide income into charge but then gives an exemption from tax for foreign source income (e.g. the Netherlands). The key feature of these two general approaches to taxation is their treatment of foreign source income. Obviously, such income is not taxed under the territorial or exemption basis. The credit approach taxes such income but generally allows a credit for foreign taxes suffered on it. Although there is in general no clear agreement as to which basis of taxation is preferable, the credit basis is perhaps becoming the more prevalent.[67] In the case of non-residents, (for example, a branch of a non-resident company), there is almost universal agreement on a single principle, namely that taxation is to be levied by a state on the income which relates to the activity carried on in accordance with the permanent establishment (or "taxable presence") principle already discussed.

Discussions on and establishment of the principles of IFL create the criteria by which specific measures of substantive IFL are judged. Thus, for example, the arm's length principle, to which reference has already been made, is clearly an accepted principle of IFL and its enactment in most double tax treaties is to be welcomed.[68] Domestic provisions, such as the U.K. provision in ICTA 1988, s. 209 (2)(e)(iv), which operate in breach of that principle (in this case by treating all interest paid to an offshore parent company as a distribution) and which are preserved in double tax treaties fall to be condemned by the criteria of IFL because they are in breach of the arm's length principle. Further, since the principles of IFL referred to are framed as principles, no sophisticated tools are required for assessing adherence to them. For example, it is generally clear

whether, in any particular case, taxation is levied by reference to the arm's length standard or whether a branch of an overseas company is taxed according to the fiscal presence test and only to the extent of its profits which are attributable to that presence.

PRE-SUBSTANTIVE PATTERNS OF IFL

The category of pre-substantive patterns of IFL is intended to refer to model bilateral double tax conventions. However, before explaining the role of such model treaties, it is first necessary to clarify the nature of double tax treaties more generally and their role in combatting international double taxation.

In general, a double taxation agreement is a treaty concluded by two or more states with the objective of regulating taxing rights in situations where the application of each state's taxing rights might otherwise result in international double taxation. Such treaties are usually bilateral and are founded on a mutually agreed set of waivers of taxing rights based on reciprocity. Double taxation agreements have also been concluded with the objective of preventing international tax avoidance or evasion. There are also double taxation agreements which have been entered into purely to encourage investment from each country into the other (e.g. the treaty between France and Saudi Arabia,).[69]

It is not the purpose of double taxation agreements to reduce disparities between taxing policies of states or equalise the tax burden between states. The objective of a double taxation agreement is merely to reconcile the competing fiscal claims of states which are parties to a treaty by the allocation of tax jurisdiction, thus avoiding international double taxation.

A simplified example of the operation of a double taxation agreement is as follows:

> X is resident in state A and receives income from a source in state B. State A levies taxes according to the residency principle whilst state B taxes on the basis of the source principle. If no unilateral relief is available, X's income from state B will be taxed by both states. The double taxation agreement negotiated between the two states will reconcile the differing tax systems by allocating the taxing right to either state A or state B or to both by a pre-arranged formula.

The example illustrates the primary objective of double taxation agreements, namely the avoidance of international double taxation and the consequent promotion and facilitation of the international exchange of goods and services and the free movement of capital and persons.[70]

In theory at least, taxing rights are allocated to each state by reference to the criterion of which state has the better claim to exert the taxing right in question, the "better claim" being determined by the principles of IFL.

In practice, things are occasionally somewhat different. The process of negotiating double taxation agreements and allocating taxing rights reflects the self-interest of the countries concerned.[71] Since all states are eager to obtain the maximum amount of revenue at all times, they naturally seek the largest possible slice of the available tax cake, thus making the allocation of taxing rights a source of considerable contention during the negotiating process. As observed by Korn, Dietz and Debatin:

> "In the final analysis, the conflict rules of each double tax agreement and the way in which they stress certain given connecting factors, are the result of tough bargaining over the economic and revenue interests of the two treaty partners"[72]

An example of the self-interested attitude of states in the bargaining process is contained in the U.S. Senate Finance Committee report on the Australian and New Zealand treaties which notes that in tax treaty negotiations;

> "[the] central issue is whether the final agreement represents a bargain which is sufficiently favourable overall to the United States that it should be ratified"[73]

From the point of view of the development of IFL, it is a regrettable, if perhaps inevitable, fact that considerations of international fiscal equity and neutrality may be overlooked while the states involved tenaciously adhere to a purely "business basis" style of negotiating double tax agreements.

The conventional wisdom on the effect of double taxation agreements is that they have merely a "negative" effect since they cannot add to the domestic tax legislation of a state and work only to leave the power to tax restricted, repressed or unchanged. On this view, the taxpayer can only benefit from the operation of a double tax agreement. However, there are cases where the taxpayer may be adversely affected by a treaty. For example, the associated enterprise article contained in most double taxation agreements, is now being invoked by tax authorities to re-allocate profits from one country to another with the possible consequence of more profits being subject to a higher-tax jurisdiction[74] or, as noted, the failure of the mutual agreement procedure can also lead to instances of double taxation. The article relating to exchange of information which is also contained in most double taxation agreements may also act against the taxpayer's own best interests.[75]

Notwithstanding the possible disadvantages which may accrue to a taxpayer from a double taxation agreement, the very existence of a treaty relationship is generally attractive to investors and in itself appears to bring benefits to the signatory states:

> "it is noticeable again and again, when investments are being planned, that legal certainty, dependable tax forecasts and reliable tax terms for investors rank high in importance. Accordingly, investment in a country with which a treaty exists for the avoidance of double taxation has a much better chance than other investment projects"[76]

Since double taxation agreements are treaties between states in accordance with the principles of public international law, they become binding as soon as they are ratified. In some countries they also gain domestic validity on ratification. In the U.K., for example, any double taxation treaty which has been incorporated into U.K. law by an Order in Council will take effect under ICTA 1988 s. 788 and CGTA 1979 s. 10[77] to the extent it provides for:

(a) relief from income tax or corporation tax in respect of income or capital gains; or

(b) charging the income or capital gains arising from sources in the U.K. to persons not resident in the U.K.; or

(c) determining the income or capital gains to be attributed to persons not resident in the U.K. and their agencies, branches or establishments in the U.K. or to persons resident in the U.K. who have special relationships with persons not resident; or

(d) granting persons not resident in the U.K. the right to a tax credit in respect of dividends paid to them by U.K. companies.

The Types of DTAs

Whilst there are other types, three distinct types of treaty can be identified. First, there are limited agreements that deal only with the profits of shipping and air transport undertakings.[78] Such agreements cater for the situation where such an enterprise is resident in one country but carries on business in the other. The

agreement will usually provide that only the country in which the undertaking is resident may tax its profits.

The second category of treaty relates to estate and gift taxes. These are becoming more common but are outside the scope of this thesis.

The third and most common type of treaty is the comprehensive double taxation agreement which has as its primary objective the relief of double taxation on all or substantially all forms of income. It is this type of treaty which is of central significance to the present discussion.

There is a highly developed network of comprehensive double taxation treaties between the more developed countries,[79] although developing countries have been slower to conclude such treaties. There are a number of factors that account for this. The chief problem seems to have been the feeling on the part of developing countries that the existing provisions of taxation treaties do not take account of the special treaty requirements of developing countries. The advent of the U.N. Model Double Taxation Convention in 1979, drafted with the specific intention of promoting taxation treaties between developed and developing countries, may lead to a reversal of this situation, though there still remain a number of factors weighing against such a development.[80]

The first double taxation agreement between a developed country and an Arab state of the Persian Gulf was concluded between France and Saudi Arabia in 1980. Treaties between capitalist and Soviet bloc countries were non-existent until the U.S.-Soviet Union treaty of 1973.

The Contents of Double Taxation Agreements

Although the detailed text of articles can vary quite widely, double taxation agreements generally follow a similar pattern, reflecting the fact that they will usually be based on one of the various model treaties (considered below).

The U.S.-U.K. Agreement may be taken as an example.[81] The Agreement begins and ends with procedural matters. Articles 1 and 2 cover the personal scope of the Treaty and the taxes covered while the final two Articles, 28 and 29, deal with the entry into force and termination of the Treaty.

The main body of the Agreement comprises the substantive articles. The U.S. - U.K. Treaty follows the normal pattern of dealing first with the definitions of general terms (Article 3). The Treaty then delineates the fiscal jurisdiction of the two states with articles on what is to count as fiscal residence (Article 4) and what constitutes a permanent establishment (Article 5).

Most of the remaining articles assign the jurisdiction to tax different types of income and capital. There are generally three possible approaches to this assignment of tax jurisdiction.

The first approach is to assign exclusive jurisdiction to tax a particular type of income to one of the contracting states. For example, Article 8 of the U.S.-U.K. Treaty stipulates that "profits derived by an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State".

The second approach is to assign non-exclusive jurisdiction to tax a particular type of income to one of the contracting states (usually the state of residence) but to allow the other state to impose a tax up to a maximum percentage which is fixed in the treaty. Article 10 of the U.S. - U.K. Agreement follows this approach in providing that dividends may be taxed in the state of residence of the payee, but that the state of source may also impose a tax not exceeding 15% of the gross amount of the dividend.

The third approach is to assign primary jurisdiction to tax a particular type of income to one of the contracting states (normally the state of source) but to allow the other state also to tax the income. Where the other state does also tax the

income, relief from double taxation is given. Thus, in the U.S.-U.K. Treaty, Article 6 provides that income from real property may be taxed in the Contracting State in which the property is situated. If such income is also taxed by the other State relief from double taxation will be provided under Article 23 (Elimination of Double Taxation) by means of the credit method.

Article 22 provides that all income not specifically dealt with in the Articles of the Convention shall be taxable only in the state of residence.

As well as the provisions designed to avoid international double taxation, a treaty will normally contain other articles dealing with non-discrimination, mutual agreement procedure and the exchange of information and administrative assistance.

These are covered in the U.S.-U.K. Agreement by Articles 24, 25 and 26 respectively.

Model Conventions

It is generally agreed that the best method of combating international double taxation is by bilateral tax conventions. It has further been perceived as desirable to harmonise these conventions in accordance with uniform principles, methods, rules and definitions. The O.E.C.D. has observed that it is;

> "most desirable to clarify, standardise, and guarantee the fiscal situation of taxpayers in each Member country who are engaged in commercial, industrial or financial activities in other Member countries through the application by all Member countries of common solutions to identical cases of double taxation"[82]

The field of IFL is still nascent and it is still too early to expect conventions to achieve a unification of international tax law such as is found in conventions on

bills of exchange, cheques and international commercial law. Nonetheless, work carried out over the last sixty years has achieved some measure of agreement on the structure and main principles of double taxation conventions. A great deal of this work has been carried out in the preparation of model conventions. It is no exaggeration to state that a considerable amount of this work has contributed to the establishment of the general principles of IFL. It is for this reason that work on double taxation agreements has been of such importance in the development of IFL.

The aim of model conventions has been stated to be the provision of "a means of settling on a uniform basis the most common problems which arise in the field of international double taxation".[83] These conventions normally comprise a draft model convention and detailed commentaries on the articles of the model treaty. The commentaries discuss the principles underlying the provisions of the model convention as well as the substantive content of the treaty. This makes them of great practical assistance in the interpretation and application of the convention and in the settlement of disputes. For example, the Commentary to the O.E.C.D. Model Convention has recently been referred to by the U.K. courts for this purpose.[84] Similarly, it will often be the case that statements or guidance based on the O.E.C.D. Commentary will be of direct assistance in the application of the substantive provisions which comprise IFL:

> "As these commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the governments of Member countries, they are of special importance in the development of international fiscal law. Although the commentaries are not designed to be annexed in any manner to the conventions to be signed by Member countries, which alone constitute legally binding international instruments, they can nevertheless be of great assistance in the application of the conventions and, in particular, in the settlement of any disputes."[85]

However, due to differences in taxation systems and interests involved, it is common to find model conventions accompanied by reservations lodged by some states on certain points where unanimous agreement was not possible.

History of Model DTAs

It follows from the comments that have already been made that the history of work on double taxation treaties is in large measure the history of the development of IFL. International collaboration on the subject of international double taxation goes back as far as 1921 when the League of Nations started work on the avoidance of international double taxation. This work led to the first model bilateral convention in 1928 and later to the Model Conventions of Mexico (1943) and London (1946). The O.E.C.D. carried on this work after World War 2. In 1963, the Fiscal Committee of the O.E.C.D., which had been created in 1956, submitted a report entitled "Draft Double Taxation Convention on Income and Capital" (followed in 1966 by a Draft Convention on the taxation of estates and inheritances).[86] The 1963 O.E.C.D. Draft Convention has been revised and the result is a text of the Convention entitled "Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital",[87] which is more usually referred to as the O.E.C.D. Model Convention.

Meanwhile, in the mid 1960s, the United Nations began to renew its interest in the problem of international double taxation. Having noted the O.E.C.D.'s admission that "the traditional tax conventions have not commended themselves to developing countries,[88] the U.N. set out to provide a model convention which would promote the conclusion of taxation treaties between developed and developing countries. The United Nations Group of Experts on Tax Treaties Between Developed and Developing Countries was accordingly created in 1967 and the Group's efforts culminated in 1979 in the "United Nations Model Double Taxation Convention Between Developed and Developing Countries".

A third modern model convention is the U.S. draft of 1977, revised in 1981.[89] This model convention has been used as the basis for treaty negotiations by the U.S. but has not generally been adopted by other countries and has recently been withdrawn by the U.S.. There is also an Andean Pact model convention[90] and a model convention used for negotiations between A.S.E.A.N. members.[91]

The Use of Model Conventions

Virtually all modern comprehensive double tax agreements are either based on, or draw heavily from, one or more of the model conventions. This is to be welcomed since it reflects a general consensus on a wide variety of the important principles of IFL which are enacted in such treaties. Most recent bilateral taxation conventions follow the pattern of the O.E.C.D. Draft. The existence and influence of this Draft Convention has made it possible to negotiate bilateral treaties on a common basis thereby creating an important degree of harmonisation. The O.E.C.D. Model rests on two general assumptions:

(a) the country of residence will eliminate double taxation by using the credit or exemption method to prevent international double taxation.

(b) the country of source will in turn reduce the scope of its jurisdiction to tax at source and also the rates of tax where jurisdiction is retained.

The reference in (a) above to the credit and exemption methods is important and requires further clarification. As indicated, the two methods are both concerned with the removal of international double taxation. There are several possible methods of relief from international double taxation. The most commonly used methods are relief by exemption and relief by credit. Under the exemption method, income or capital which is taxable in one state (usually the state of source) is then exempted from tax in the other state (usually the state of residence). The exemption method is based on the assumption that the enterprise should be enabled to operate in the relevant country in the tax system prevailing

in that country. It is therefore accepted that the country will fix the tax terms under which the enterprise may operate.

Where relief is given by the credit method, income or capital taxable in one state (usually the state of source) is then taxed in the other state (usually the state of residence) but the tax levied in the first state is credited against the tax levied by the second state.

> "The essential feature of the credit method is that the investor's country of residence treats the foreign tax, within certain statutory limits, as if it were a tax deemed to be paid to itself".[92]

There are advantages and disadvantages to both these methods of relief from international double taxation. For this reason, the choice of methods is left to individual states in the O.E.C.D. Model Double Taxation Treaty.[93] However, there is an increasing tendency on the part of states in the developed world to prefer the credit method.[94] There are two explanations for this trend. First, the desire for ever-increasing tax revenues and, second, the aim to counteract tax avoidance schemes whereby assets are transferred to countries with low tax rates. Both the above reasons are based on the fact that the overseas income is brought into tax with a credit available to the extent overseas tax has been paid. Thus, the use of low tax states (for example, for overseas branch activities) will not, under the credit method, achieve a tax saving since the overseas income will ultimately be subject to the full domestic tax rate. Both the countries which are considered in this thesis (the U.S. and the U.K.) adopt the credit method to relieve international double taxation.

Other methods of relief from international double taxation may also be mentioned. A company may be allowed to deduct amounts of foreign tax paid as an expense in arriving at the figure of profits liable to domestic tax. Relief may also be granted by allowing a deferral of tax, for example, where a state taxes income from abroad only when it is remitted to the home country.

The latter two methods of relief are applied unilaterally by a state. Relief by the methods of credit and exemption can be given unilaterally but they are also a common feature of bilateral double taxation agreements.

The approach reflected in the O.E.C.D. Model Convention has been accepted by developed countries, but it has not found favour with developing countries, principally because of their reluctance to reduce or yield taxation at source to the extent required by the O.E.C.D. Model. Therefore, the U.N. Draft, expressly geared to the requirements of developing countries, does not give any percentages for the rates of tax at source on dividends and interest and assumes that a tax at source on royalties is equally justified (whereas under Article 12 of the O.E.C.D. Model Convention royalties are taxable only in the state of residence of the taxpayer, provided that the resident is the beneficial owner of the royalties). Substantial departures from the O.E.C.D. text are also to be found in the United Nation's definition of "permanent establishment" (Article 5).

The U.S. Model Treaty was produced in response to the fact that the United States has found it difficult to use the O.E.C.D. Model Convention in its present form. However, it has been suggested that the current tendency in the U.S. appears to be to move towards the O.E.C.D. Model on the assumption that it will gradually become acceptable to the U.S. taxation authorities.[95]

Other Uses of DTAs

The primary objective of most double taxation agreements is, as has been noted, the allocation of taxing rights in order to avoid international double taxation. A secondary, but increasingly prominent function of double taxation agreements is their use as devices to attack international tax avoidance and evasion. In the light of the developments over the last two decades, treaties have become an important weapon in a state's armoury against international avoidance and evasion. This aspect of double taxation agreements is considered separately below.

Double taxation agreements are also used to accomplish other secondary objectives.[96] The most important of these is perhaps the encouragement of private investment in developing countries. Whilst most agreements are stated to be conventions "for the avoidance of double taxation",[97] some developing countries have argued that treaties should go beyond this and include specific provisions actively to encourage investment in their countries. An example would be a provision whereby a developed country gives a special tax credit or deduction to companies investing in developing countries.

None of the model conventions has adopted this approach and it has not met with a favourable response from developed countries. However, where developing countries have themselves introduced tax incentives in order to attract foreign investment (such as tax holidays, tax exemptions for re-invested profits and accelerated depreciation allowances), developed countries have often maintained the effect of this relief by appropriate mechanisms in their double taxation agreements with developing countries. Unless such relief is recognised by developed countries using the credit method for relief from international double taxation, the effect of tax incentives given in developing (source) countries is merely to increase the tax to be paid to the developed (residence) country.[98]

Multilateral Agreements

The formulation and application of a multilateral convention is attractive from the perspective of IFL because it would involve a much improved uniform approach to a number of key issues of international taxation. Such an approach would further reduce the likelihood of international double taxation, whether juridical or economic, and enhance the conditions for international trade and investment. In the long term, the existence of such a convention might also influence the domestic law of contracting states, thus providing a further impetus to the harmonisation of domestic tax law which is relevant to the taxation of international business or investment.

Despite the general acceptance that international double taxation should be eliminated and despite the increasing international co-operation between states and international organisations, the prospect of a multilateral international tax agreement remains almost as remote as ever. Calls have been repeatedly made for such a treaty since 1925.[99] Although little has been achieved to date there is nonetheless, and notwithstanding a number of setbacks and difficulties, an overall trend toward increasing multilateral co-operation and collaboration in approaching a number of issues facing IFL. For example, the O.E.C.D. Committee on Fiscal Affairs is actively working on a number of matters relevant to the development of IFL[100] and the recent attempt to produce a multilateral convention on the exchange of information and mutual assistance between tax authorities [101] does at least reflect the overall trend toward a more concerted multilateral approach in a number of areas. Nonetheless, it must be acknowledged that both the above examples fall short of providing any evidence that a multilateral taxation agreement is still anything other than a long-term possibility.[102]

There is however one multilateral taxation agreement in existence. This is a convention on the taxation of road traffic. In this treaty of 1956, which replaced an earlier agreement of 1931, thirty states originally agreed that tax on motor vehicles should be levied only by the state in which the vehicle is registered.

The principal difficulty facing any multilateral convention is that of reconciling the requirements of potential signatory states. Whilst the drafting of bilateral treaties can be tailored to take account of the participants' domestic tax policies, it is doubtful whether a multilateral taxation convention could achieve the same result: Where a bilateral taxation treaty has the task of reconciling only two domestic tax systems, a multilateral convention would be faced with the task of satisfactorily reconciling the competing claims and requirements of several states.[103]

This difficulty is exemplified by the efforts of a working party created by the Council of EFTA[104] following the 1963 recommendations of the O.E.C.D. Council. The working party's brief was to investigate the technical feasibility and

practicability of a multilateral taxation agreement. After five years of work the working party reported that in the light of the technical difficulties facing such a project, the most that could be achieved was an outline convention incorporating the most basic areas of general agreement.

Since this would mean that the most important provisions would still have to be negotiated by bilateral treaty, the working party agreed that the conclusion of a multilateral taxation agreement could not be recommended at present.[105]

The difficulties facing multilateral conventions have been recognised by both the U.N. Group and the O.E.C.D.'s Committee on Fiscal Affairs, the latter body having stated that it might, however;-

> "be possible for certain groups of Member countries to study the possibility of concluding such a Convention among themselves on the basis of the Model Convention, subject to certain adaptions they may consider necessary to suit their particular purpose".[106]

The feasibility of regional conventions has also been noted by the U.N. Group of Experts.[107]

The possibility of a regional convention is well illustrated by the efforts of the EEC to conclude a multilateral agreement. In 1962, the Neumark Report stated that:

> "The best way for ensuring uniform provisions on double taxation is without doubt the signing of a multilateral agreement by the Member States of the E.E.C. The Fiscal and Financial Committee is also of the opinion that endeavours to eliminate double taxation within the E.E.C. should ultimately lead to the signing of a multilateral agreement based on the Model Convention of the O.E.C.D.."[108]

Alongside efforts to prepare a draft multilateral tax convention have been efforts towards harmonising substantive fiscal law within the E.E.C. Since the main difficulty facing a multilateral convention is the variety of domestic tax systems, this process of harmonisation could be expected to facilitate the drafting of such a convention for the E.E.C. countries.

However, whilst progress has been made in some quarters, the project as a whole is proving considerably more difficult than expected. In view of the radical differences in domestic tax systems and policies, this is hardly surprising and it is not yet possible to report any real progress toward the preparation of an E.E.C. multilateral taxation convention, or, for that matter, toward the harmonisation of substantive fiscal law in the field of direct taxation within the E.E.C.

The longer-term prospects of a multilateral convention may be somewhat brighter. The increasing attention paid to issues of international taxation might in the long run lead to the development of generally accepted basic principles of IFL which would pave the way for such a convention. Since the primary goal of IFL is the removal of international double taxation and since taxation treaties are one of the primary vehicles used to this end, it is likely that efforts will continue to be made in future toward the preparation of a generally acceptable multilateral convention.

THE SUBSTANTIVE ENACTMENTS WHICH CONSTITUTE IFL

The substantive enactments which constitute IFL are in effect the legal expression of the prescriptive policies and principles discussed in the earlier sections of this chapter.

These substantive enactments include specific bilateral double tax conventions and domestic tax law and claims to jurisdiction, which may include provisions to relieve international double taxation as well as unilateral anti-tax haven legislation of the sort discussed in this thesis. The specific enactments contained in double tax

treaties are often different in character to legislation dealing simply with domestic tax issues. For example:-

> "Bilateral agreements for regulating some of the problems of double taxation began, at any rate so far as the United Kingdom was concerned, in 1946. The form employed in all agreements, is derived, I believe, from a set of model clauses proposed by the fiscal commission of the League of Nations. The aim is to provide by treaty for the tax claims of two governments both legitimately interested in taxing a particular source of income either by resigning to one of the two the whole claim or else by prescribing the basis on which the tax claim is to be shared between them. For our purpose it is convenient to note that the language employed in this Agreement is what may be call international tax language and that such categories as "enterprise", "industrial or commercial profits" and "permanent establishment" have no exact counterpart in the taxing code of the United Kingdom."[109]

With regard to the status of the "rules" of substantive IFL, there are two distinct points which are commonly debated amongst international tax commentators. The first relates to whether these rules are substantive laws in themselves or are merely conflict rules. The second is whether there are limits to the power of a fisc to legislate in the area of fiscal law. Each point will be considered briefly below. However, since they are of merely peripheral importance to this thesis, the discussion of them will be brief.

Dealing with the issue simply in the context of the U.K., it is acknowledged that, whatever the provisions contained in a double taxation treaty, that treaty must be incorporated into U.K. law before it will be recognised by the courts.[110] This may suggest that the provisions of a double tax treaty merely regulate whether the various relevant provisions of domestic law are allowed or not allowed to operate in a situation in which the treaty applies. However, the fact that a treaty can

change the position of a taxpayer from that which may have applied in the absence of the treaty and can impose different rates of tax, or remove a charge to tax, as compared with domestic law indicates the substantive effect of such treaties. Indeed, the Inland Revenue are occasionally known to take the view, based on an interpretation of ICTA 1988, s. 788, that double tax agreements are capable of imposing taxation where none would otherwise arise under domestic legislation.[111]

Moreover, the fact that U.K. courts now seem prepared to consult such documents as the Commentary to the O.E.C.D. Model Double Taxation Convention in appropriate circumstances[112] does, at the very least, indicate the different character of the provisions contained in double taxation agreements as compared to provisions having a purely domestic effect, notwithstanding that such agreements are required to be incorporated into U.K. law to be effective.

However, it should be emphasised that the view of the writer that the enactments of IFL in double taxation treaties should be regarded as substantive tax law is in no way related to the main arguments of this thesis, where the discussion concentrates on the principles of IFL, rather than the specific enactment of those principles.

The second focus of debate on IFL has been the question whether there are limits to the jurisdiction of a state to levy tax imposed by general international law. With regard to this debate, it seems to be established that:

> "No rules of international law exist to limit the extent of any country's tax jurisdiction."[113]

However, the majority of exponents of this view[114] accept that the extra-territorial ability of a fisc to enforce its tax laws render its ability to levy taxation without jurisdictional limit of academic interest only. This means that there is broad agreement between the two parties to this debate that taxation can in practice be

levied (and collected) only if there is a reasonable link or connection between the tax subject and the fisc concerned. Several writers consider this position is a product of general international law[115] whilst others, as explained above, do not agree with this view but admit that, unless such a connection exists, a state will be unlikely to enforce its jurisdiction.

Here again, this conclusion is not necessary or related to the arguments of this thesis. Indeed, this thesis provides some grounds for the view that the debate is misplaced. It is submitted that the more important topic, relating to the development of a consensus on what the bounds of jurisdiction should be (and why) has to some extent been obscured by the less-progressive and narrowly-academic concentration on what tax jurisdiction is or may be in the context of the debate referred to above.

CURRENT STATUS AND SIGNIFICANCE OF IFL AND THE POLICIES AND PRINCIPLES OF IFL

It is probably fair to say that the primary objective underlying IFL is reasonably well-known by tax practitioners but not often expressed or acknowledged. However, the principles (whether fully-formed or being currently developed) which seek to apply in more concrete form that concept are more familiar to all those involved in the field of international taxation. This state of affairs reflects the nascent or emerging status of IFL and also suggests that, while there is general acceptance at an academic level of the content and consequences of the objective and policies of IFL, that content and those consequences are not yet widely perceived in the conceptualised manner suggested by this thesis.[116] Before concluding this chapter on the nature of IFL it is necessary to offer some further comments on the status and significance of IFL and particularly the policies and principles underlying IFL.

As has been demonstrated, the policies and principles of IFL are of fundamental importance because they have as their objective the realisation of the primary

objective underlying IFL, which is broadly the facilitation of international trade and investment. As has been noted, this is an economic objective which in turn rests upon the proof, expounded by David Ricardo,[117] that international collaboration by way of trade is advantageous to all concerned.[118]

It is submitted that the reason the particular major principles of IFL (discussed earlier) have developed (and continue to develop) is because they represent a set of practicable rules to achieve that primary objective for which there is such general agreement. In the opinion of this writer a convincing economic analysis of these principles could be made to substantiate this view, although such an undertaking is clearly outside the scope of this thesis.[119]

Whilst the substantive enactments which constitute IFL have merely a legislative (or quasi-legislative) force, these policies and principles underlying IFL, which are clearly of a different character, have a prescriptive character. Given that the policies and principles underlying IFL have such a prescriptive force and that it is possible to identify criteria or goals of IFL, it follows that the policies and principles underlying IFL can be applied both to evaluate and appraise existing legislation and also to develop new approaches to problematic issues of international taxation. Indeed, the use of IFL in this way is already a common feature of the literature dealing with matters of international taxation. For example, in a discussion of unitary tax systems (being methods for allocating global profits between associated companies) appearing in a 1985 O.E.C.D. document it is stated that:-

> "....such systems do introduce an irritant in the taxation of international investment and may result in taxation not in accord with internationally accepted principles of taxation of income from such investment."[120]

The reason that these "internationally accepted principles of taxation" are of considerable significance is because they are intended as an application of the

overall goals of IFL This point can be illustrated further. It is widely accepted that, as a matter of law:

> "There is no general rule of international law which would prohibit international double taxation. Every state is free to establish its own tax system and to circumscribe the liability to its taxes."[121]

Whilst the above proposition may be true as a matter of strict law, there is a principle (or prescriptive rule) of IFL which does prohibit international double taxation for reasons which are as obvious as they are compelling. Thus, IFL requires that the revenue-raising function of the fisc is suspended or limited in certain cases where this is necessary to achieve the primary goals of IFL. Such prescriptive rules of IFL are therefore of fundamental importance to the development of good international tax law.[122]

It is therefore through the "concretized" principles of IFL that the primary objective underlying IFL may be implemented.

This point is illustrated by the very existence of the League of Nations' Technical Experts Committee Report in 1925.[123] The task of that Committee was to "bring about a more equitable assignment of taxation to prevent the evil effects of double taxation" but from an "administrative and practical point of view".[124] In contrast to the work of the earlier group of eminent economists who were concerned with determining the most appropriate basis of taxation [125] the Technical Experts were concerned with practical ways of implementing measures to prevent double taxation. This led directly to the development of the principles underlying IFL, as explained by Mitchell B Carroll, writing in 1939:

> "Persistently and quietly for the past two decades, technicians have laboured at Geneva to reduce the tax burdens and barriers that obstruct the movement of trade and capital between countries. When they first began to meet, there were practically no generally

> recognised limits on tax jurisdiction, and the same overlapping of claims of different jurisdictions on the same income or property resulted in confiscatory levies.....Where an enterprise does business in several different countries (as, for example, where it produced raw materials in one, processes them in another, and sells them in a third) principles and methods of determining the income properly attributable to each have been devised. Correlative principles have been proposed for the imposition of property taxes. Principles for preventing the dual imposition of taxes on the death of individuals have also been proposed. To implement these provisions for relief, formulae for co-operation between Governments in assessing and collecting taxes have been suggested.....These principles and formulae have been incorporated in the draft Conventions of 1928 and the subsequent years. During their development and since then, officials meeting at Geneva have followed these precepts in concluding bilateral treaties on behalf of their respective Governments. The pioneer work of the technicians at Geneva has been reflected in the practical accommodation of existing tax systems to these principles."[126]

In view of the discussion in this chapter, it will be appreciated that unilateral legislation enacted to tax the profits of companies located in overseas tax havens inevitably raises important questions relating to the policies and principles of IFL. For example, questions of the jurisdiction to tax in such circumstances, the degree to which such legislation conforms to the two major policies of IFL, equity and neutrality, or conforms to the various principles of IFL etc. will need to be considered in evaluating the effects of such legislation. The criteria which will be used to evaluate such legislation are those which flow from the policies and principles underlying IFL, as discussed in this chapter. These criteria are clearly the proper measure with which to review the legitimacy of such unilateral legislation since as, substantive enactments of IFL, this legislation should conform with the major policies and principles underlying IFL. If this were not the case,

then, on the basis of the earlier discussion contained in this chapter, there would otherwise be a danger that this unilateral legislation created effects contrary to the primary objective underlying IFL.

However, before proceeding to a review and evaluation of the legislation itself, it is first necessary to examine the two relevant concepts "international tax avoidance", and "tax havens".

CHAPTER 1 - NOTES

1 It should be emphasized that the hierarchy referred to and posited is the author's own perspective of the relationship between all the elements included in that hierarchy. Other authors have attempted diagrammatic depictions of the scope of fiscal law -see for example, A Knechtle, "Basic Problems in International Fiscal Law" (Kluwer, 1979) at pp. 12-13 - but these tend to be concerned, as in Knechtle's case, with whether the rules of IFL are merely a set of rules about conflict law or whether they are rules of tax law. It is in fact surprising how little discussion there is available of the conceptual framework in which IFL is located. This makes it particularly difficult to place the conceptual overview which is set out in the discussion in the chapter in the context of any existing analysis of the position.

2 There are various model bilateral double taxation treaties. The two leading texts are those of the OECD (Report of the OECD Committee on Fiscal Affairs, Model Double Taxation Convention on Income and Capital (Paris, 1973)) and the UN (UN Department of International Economic and Social Affairs, Model Double Taxation Convention Between Developed and Developing Countries (New York, 1980). The OECD model convention and commentaries have just been updated as of September 1992, although relatively little in the text of the model convention (but not the commentaries) has changed.

3 For example, see Dr. V. Langbein, "Double Taxation Agreements: Caught in the Conflict Between National Law and International Law", [1987] Intertax pp 145-157.

4 See, for example, A.H. Qureshi, "The Freedom of a State to Legislate in Fiscal Matters under General International Law", I.B.F.D. Bulletin, January 1987, pp 14-21.

5 Report of the OECD Committee on Fiscal Affairs, Model Double Taxation Convention on Income and Capital (Paris, 1973), p. 7.

6 UN Department of International Economic and Social Affairs, Model Double Taxation Convention Between Developed and Developing Countries (New York, 1980), p. 1.

7 AA Knechtle, Basic Problems in International Fiscal Law, (Kluwer, 1979).

8 "The EEC's programme is expressed in article 2 of the Rome Treaty which defines its far-reaching aims as follows:-

> "The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it." - see Treaty establishing The European Economic Community, Rome, 25th March 1957. Text in force on 1st January 1973, London, HMSO 1973, p.5.

9 Knechtle, op cit at note 7, p.6.

10 Note 7, Ibid, pp.7-8.

11 Note 7, Ibid, p.9.

12 Note 7, Ibid, p.10.

13 For a fascinating account of the early measures against double taxation, see Mitchell B Carroll, op. cit at Note 17, Ibid, pp. 6-10.

14 The four economists were Professor Bruins of the Netherlands, Professor Einaudi of Italy, Professor Seligman of the U.S.A. and Sir Josiah Stamp of the U.K.. Their report was published on April 5th, in 1923. (League of Nations, Economic and Financial Commission, Report on Double Taxation submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp (Geneva, April 5th, 1923) EFS 73, Document F.19.

15 The seven European countries were Belgium, the U.K., Czechoslovakia, France, Italy, the Netherlands and Switzerland.

16 League of Nations, Report and Resolutions Submitted by the Technical Experts to the Financial Committee, Double Taxation and Tax Evasion (Geneva, February 7th 1925), Document F.212.

17 For a useful summary of the early work of the League of Nations on matters relation to double taxation, see Mitchell B Carroll, "Two decades of progress under the League of Nations" (Geneva, June 22nd, 1939) Document F/Fiscal/111.

18 Report of the O.E.C.D. Committee on Fiscal Affairs; Model Double Taxation Convention on Income and Capital (Paris, 1977) page 7. The

definition was first introduced by the 1967 O.E.C.D. Draft Model Double Taxation Convention.

19 Quoted in B. Runge, "International Double Taxation with Regard to Transnational Companies", Intertax 1977/5 page 180.

20 For example, in the O.E.C.D. Model Double Taxation Convention there is a long discussion relating to the avoidance of judicial international double taxation, yet it is simply said of economic international double taxation that "if two states wish to solve problems of economic double taxation, they must do so in bilateral negotiations". (Report of the O.E.C.D. Committee on Fiscal Affairs; Model Double Taxation Convention on Income and Capital, (Paris, 1977), page 145.)

21 Arnold Knechtle, Basic Problems in International Fiscal Law (London, 1979), page 42, which contains a fuller discussion of international double taxation arising by means of indirect taxes.

22 Revenue Act of 1918, ss. 222 (a) and 238 (a).

23 56 Congress Rec. 677-78 (1918), as quoted in, "A report to the Commissioner of Internal Revenue and the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy), submitted by R. A. Gordon, Special Counsel for International Taxation 12 January 1981, p. 43.

24 This is not to say that the early work of the League of National was not concerned with tax avoidance and tax evasion - indeed, the work of the Technical Experts (see note 16 above) was specifically concerned with tax evasion in addition to the problem of double taxation. However, the emphasis on avoidance and evasion seems to have developed particularly since the 1950s. The use of IFL as a means of assisting developing countries is certainly a more recent phenomenon. The UN Model Treaty (see note 2 above) - designed to facilitate such assistance - was published in 1980.

25 Note 14, Ibid.

26 The first study of the League of Nations concerned with tax evasion was the 1925 Technical Experts Report - see note 16, Ibid.

27 See note 28, Ibid.

28 Note 16, Ibid, Part III, Section I.

29 Note 17, Ibid, p. 37.

30 Note 17, Ibid, p. 28.

31 Adam Smith, "The Wealth of Nations", (reprinted in J M Dent & Sons Ltd edition (London 1910) 2 vols. The discussion (entitled "Of Taxes") is set out in Part II of Chapter II of Book V of The Wealth of Nations, at pp. 306-309 in volume 2 of the J M Dent edition).

32 It should be noted that the summary of Adam Smith's criteria in the chapter uses concepts which are now familiar - e.g. equity and neutrality - but which were not expressly used by Adam Smith in his discussion of taxation in The Wealth of Nations.

33 See further J A Kay and M A King, "The British Tax System", (2nd Edition, 1980) at pp. 203-204.

34 See further, J A Kay and M A King (note 33), Ibid, pp. 17-18.

35 See, for example, the discussion entitled "Evaluating Tax Systems" in Robert E Hall and Alvin Rabushka, "The Flat Tax", (Stanford, 1985) at pp. 306.

36 See further, for example, the Report of the Meade Committee, "The Structure and Reform of Direct Taxation", (London, 1978) at p. 20.

37 This is clearly attributable to the fact that economic discussions of taxation had in effect been commenced by Adam Smith at the end of the 18th Century - and continued by David Ricardo and John Stuart Mill in the 19th Century - some considerable time before the phenomenon of international double taxation was recognised.

38 Note 14, Ibid.

39 Note 14, Ibid, Introduction.

40 Note 1, Ibid.

41 Note 1, Ibid, pp. 20-21.

42 Note 1, Ibid, p. 20

43 Note 1, Ibid, p. 20.

44 This concept is in turn clarified by Knechtle by reference to the views of the German economist Adolf Wagner -see note 1, Ibid, p. 19.

45 David Ricardo, "The Principles of Political Economy and Taxation", reprinted in J M Dent & Sons Ltd edition (London, 1917).

46 Note 45, Ibid, chapter VII, pp. 77-93.

47 Note 45, Ibid, pp. 80-81.

48 The Ricardian Law of Association is, however, clearly explained in Ludwig von Mises, Human Action, 3rd edition (Chicago, 1966) pp. 159-164.

49 Ludwig von Mises, op cit at note 48, p. 160.

50 This interpretation is confirmed by the very first paragraph of the discussion on international efforts towards the elimination of double taxation in the OECD Model Double Tax Treaty Convention (Note 18, Ibid) which recognises that international double taxation and its harmful effects on the exchange of goods and services and movements of capital and persons "are so well known that it is superfluous to stress the importance of removing the obstacles that double taxation present s to the development of economic relations between OECD Member Countries" - see esp. para. 3 on p. 7.

51 Adolf Wagner, Lehr - und Handbuch der politischen Ökonomie, 2nd ed. Leipzig 1890, p. 380, as referred to in Knechtle op cit at note 1 above, Ibid, p. 19.

52 O.E.C.D. Model Convention, (See note 59) Article 24.

53 D W Williams, Trends in International Taxation, (Amsterdam, 1991) pp. 99-100.

54 Murray Rothbard, Power and Market: Government and the Economy, (Menlo Park, California 1970), page 65.

55 In the U.K., for example, the fiscal policy of the former Chancellor of the Exchequer, Mr. N. Lawson, M.P., is radically different from the fiscal policies operated by his predecessors (from his own party and from the Labour party) within the last two decades.

56 United Nations, Department of International Economic and Social Affairs, Model Double Taxation Convention Between Developed and Developing Countries (New York, 1980).

57 Although IFL in this sense has been developing arguably for approximately 100 years, it was only in 1921, with the involvement of the League of Nations that the subject took on a truly international significance.

58 Note 16, Ibid.

59 Report of the O.E.C.D. Committee on Fiscal Affairs; Model Double Taxation Convention on Income and Capital (Paris, 1977) page 73.

60 There is a separate "permanent establishment" article in both of these model double taxation conventions. The purpose of the article is to clarify which activities will amount to a taxable presence in a treaty state (and so amount to a "permanent establishment") and which will not.

61 United Nations Department of International Economic and Social Affairs; International Co-operation in Tax Matters (New York 1984) SIT/ESA/142 page 27.

62 See, for example, the discussion in the League of Nations Economists Report of 1923 - note 10, Ibid, on the Doctrine of Economic Allegiance, at pp. 20-27. For other current examples, see the remaining text of the section, passim. It should be noted that legislation may be promulgated by states which is contrary to the principles of IFL - the U.S. "superroyalty" proposals contained in the U.S. White paper on intercompany pricing (U.S. Treasury Department and IRS, A Study of Intercompany Pricing, Discussion of October 18, 1988) have been criticised on this ground (as a breach of the arm's length principle), although the White Paper itself maintains that all proposals are consistent with the arm's length principle - see especially chapter 7 of the White Paper.

63 CT Plambeck, "The Taxation Implications of Global Trading". Tax Notes, August 27 1990, p.1143 at 1156.

64 Dr. Berndt Runge, "International Double Taxation with Regard to Transnational Companies", Intertax 1977/5 180 at page 191.

65 Place of incorporation; place of effective management and place of central management and control are three of the various possibilities.

66 Various other states might equally be cited. However, there exist also states which asset their right to tax residents on a global basis but in fact generally exempt foreign source income, e.g. France, the Netherlands. The result may be similar to that applying where a state levies tax on a territorial basis but the two bases are conceptually quite different. This is illustrated by, for example, the fact that France does in fact tax a number of major multinational companies on a global basis and that an overseas branch of a Dutch company may nonetheless be subject in part to Dutch taxation as a result of the domestic rules that apply in connection with the computation of overseas branch income and exchange differences.

67 For example, Finland has recently switched to a worldwide basis with a tax credit system in respect of dividends received to replace its former exemption system. Sweden's participation exemption in respect of dividends received from overseas companies has also recently been modified to implement a world-wide basis with a credit system where the

relevant overseas company paying the dividend is subject to rates of tax of less than 15%.

68 The "associated enterprises" article, which is contained in virtually all modern treaties (usually based on Article 9 of the O.E.C.D. Model Convention) is the best example of this.

69 France - Saudi Arabia (Income and Inheritance) Tax Treaty, concluded 18 February 1982, reproduced in European Taxation Service, Section C, I.B.F.D. 1983.

70 Report of the O.E.C.D. Committee on Fiscal Affairs; Model Double Taxation Convention on Income and Capital, (Paris, 1977), Commentary on Article 1, page 47.

71 See further Wolfgang Ritter "Requirements of Developed Countries from Double Tax Treaties with Developing Countries", I.F.A. Seminar, U.N. Draft Model Taxation Convention, (Kluwer, 1979), pages 45-46.

72 H. Korn, G. Dietz, H. Debatin; Doppelbesteuerung, Sammlung der zwischen der Bundesrepublik Deutschland und dem Ausland bestehenden Abkommen uber die Vermeidung der Doppolbesteuerung, (Munich 1972), page 6. Quoted by Knechtle, op. cit. at note 21, page 164.

73 As quoted by W. P. Streng; "U.S. Taxation of International Business Transactions 1983"; Intertax 1984/4 p.137 at p.145.

74 In the U.K. for example, the Inland Revenue may seek to apply the associated enterprises provisions of a relevant double tax treaty - even if their scope is wider than the domestic transfer pricing legislation in ICTA 1988, s.770 - based on an interpretation of the effect of ICTA 1988, s.788(3)(c).

75 For a full discussion of the potential disadvantages to taxpayers resulting from double taxation agreements, see Knechtle, op cit at note 21, pages 180-182.

76 Wolfgang Ritter, "Requirements of Developed Countries from Double Tax Treaties with Developing Countries", I.F.A. Seminar, U.N. Draft Model Taxation Convention, (Kluwer, 1979), pages 45-46.

77 Formerly ICTA 1970, s.497.

78 E.g. U.K. - U.S.S.R. Agreement of 3rd May 1974, Simons Taxes (Butterworths), Volume F, page 4261.

79 As at March 1980, 182 out of a maximum possible 276 agreements had been concluded by members of the O.E.C.D. inter se. See Council of Europe; International Tax Avoidance and Evasion, (Amsterdam, 1981).

80 Such factors include the lack in the developing countries of skilled personnel capable of negotiating DTAs; the persistent rejection of tax sparing incentives by some developed countries (most notably the U.S.); and the unwillingness on the part of developing countries to agree by treaty to give up a claim to much-needed revenue from activities carried on within its borders.

81 The U.S. - U.K. Treaty was ratified on 25 March 1980 and entered into force in April 1980. It comprises not only the Convention signed in December 1975 but also supplementary protocols signed in August 1976, March 1977, and March 1979. For text see Simon's Taxes, (Butterworths) Volume F, Double Taxation Relief and Agreements, page 3355.

82 Report of the O.E.C.D. Committee on Fiscal Affairs; Model Double Taxation Convention on Income and Capital, (Paris, 1977).

83 Note 82 Ibid, page 11.

84 Sun Life Assurance Co. of Canada v. Pearson, [1986] STC 335 at 346.

85 Report of the O.E.C.D. Committee on Fiscal Affairs; Model Double Taxation Convention on Income and Capital (Paris, 1977) paragraph 26.

86 O.E.C.D., Model Double Taxation Agreement on Estates and Gifts, (Paris, 1982).

87 Paris 1977. The revised 1977 Model Convention was produced by the O.E.C.D.'s new Committee on Fiscal Affairs, which was created in 1971. The new Committee on Fiscal Affairs is continuing the work of the former Fiscal Committee on double taxation and related issues.

88 Report of the O.E.C.D. Fiscal Committee; Fiscal Incentives for Private Investment in Developing Countries, (Paris, 1977) paragraph 164.

89 For the text of both Conventions, see P.H. Federal Taxes, Tax Treaties, (Prentice Hall 1982), Volume I, pages 1043-1059 and 1085-1098.

90 See "Andean Pact: Double Taxation Conventions", supplement to I.B.F.D. Bull 8 August 1974 and also E. Naranjo; "The Andean Pact", I.B.F.D. Bull. February 1987, p.89. The Andean Pact is comprised of Latin American States.

91 During the 6th ASEAN-COFAB Working group on tax matters, held in April 1986 in the Philippines, the delegation from Malaysia presented a model tax treaty called the Intra-ASEAN Model Double Taxation Convention on Income. The delegations agreed to harmonize the existing conventions between member countries and felt that the new model would help in this. The A.S.E.A.N. members are Far Eastern states such as Singapore, Malaysia, Indonesia and Thailand.

92 United Nations, Department of International Economic and Social Affairs; Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries (New York, 1979), page 13.

93 O.E.C.D., Model Taxation Convention (see note 59), page 150.

94 See note 67.

95 See remarks by R.J. Patrick, former U.S. Treasury official, I.F.A. Seminar; the Revised O.E.C.D. Model Double Taxation Convention on Income and Capital (Kluwer, 1977), page 32. Mr. Patrick also gives a number of reasons why the U.S. does not find the O.E.C.D. Model presently acceptable including the following; the O.E.C.D. Convention is sometimes incompatible with U.S. jurisprudence; the U.S. principle of taxing corporations incorporated in the U.S. (not resident in the U.S. as in the O.E.C.D. Model) would give rise to double taxation if not dealt with by particular provisions; U.S. rules on personal service income do not fit easily into the framework of the O.E.C.D. Model Convention.

96 One commentator suggests there are five principal purposes of comprehensive double tax treaties: (1) mutuality of relief; (2) equal and equitable treatment of taxpayers; (3) accommodation of differing tax systems; (4) resolving conflicts; (5) exchange of information. See Eric Tomsett, "Tax Treaties between Developing Countries of Asia and North America, Europe, Japan and Australia", Tax Planning International Review, 1985, p.9 at p.10.

97 For example, the double taxation treaties negotiated by both the U.K. and the U.S. are generally so expressed.

98 In the U.K., provided the double tax treaty stipulates relief by credit, the effect of ICTA 1988 s.788 is that if overseas tax relief is given in this way, the tax spared is normally to be treated as if it had been paid in the normal way and a deemed credit for double tax relief purposes is granted.

99 In 1925 the League of Nations noted that the only satisfactory method to stop tax evasion was a multilateral tax agreement. More recently, the United Nations Group of Eminent Persons recommended "that the

bilateral treaties should be as uniform as possible so as to prepare the way for an international tax agreement" on the basis that such an agreement would help remove "the present distortions in the activities of multinational corporations", (Group of Eminent Persons, The Impact of Multinational Corporations on the Development Process and on International Relations, U.N. Doc E/5500/Add 1 (1974) page 92.

100 For example, there have been recent reports on treaty shopping and the use of base companies (O.E.C.D. Committee on Fiscal Affairs, Issues in International Taxation, No. 1, International Tax Avoidance and Evasion, (Paris, 1987) and thin capitalization (O.E.C.D. Committee on Fiscal Affairs, Issues in International Taxation, No. 2, (Paris, 1987).

101 Convention on Mutual Administrative Assistance in Tax Matters, O.E.C.D. (Paris, 1988).

102 It should be noted, however, that mutual assistance in tax matters may be effected by a multilateral treaty. For example, The Nordic Convention is a tax treaty providing for extensive mutual assistance through a general exchange of information. The treaty was signed on November 9th 1973 by Denmark, Finland, Iceland, Norway and Sweden and it has been in force since 1973. It was updated in 1990.

103 The very existence of the important differences between the O.E.C.D., U.N. and U.S. model conventions highlights the diversity of thinking in the field of the principles to be applied to tax treaties and in itself casts doubt on the feasibility of a multilateral convention.

104 EFTA is comprised of the major non-EC member states in Europe; Austria, Switzerland, Liechtenstein, Finland, Sweden, Norway and Iceland.

105 Report by the working party; E.F.T.A., The Feasibility of a Multilateral Double Taxation Convention within E.F.T.A., (E.F.T.A. 64/69), 12 November 1969. See also discussion of this Report in Knechtle (op. cit.at note 21) pages 189-190.

106 Report of the O.E.C.D. Committee for Fiscal Affairs; Model Double Taxation Convention on Income and Capital (Paris, 1977) page 15.

107 U.N. Ad Hoc Group of Experts, Seventh Report, New York, note 2, page 61.

108 E.E.C. Neumark Report, page 74.

109 Ostime v Australian Mutual Provident Society 38 TC 492 at 517.

110 The Republic of Italy v. Hambros Bank Limited, [1950] 1 A11 E.R. 430 where it was held that the lack of an express incorporation into U.K. law of an international agreement to which the U.K. was a party made it incognisable in court.

111 Formerly ICTA, s.497.

112 See Sun Life Assurance Co. of Canada v. Pearson, [1986] STC 335 at 346.

113 M. Norr, "Jurisdiction to Tax and International Income", (1961) 17 Texas Law Review, p.431.

114 E.g. Knechtle, op cit at note 14, pp 40-41 and Qureshi, op cit at note 4 p.16.

115 See for example, M. Akehurst, "Jurisdiction in International Law", (1972-73) B.Y.I.L., p.145 at pp 179-180.

116 The position in the U.K. is perhaps particularly undeveloped due to the relatively undeveloped state of taxation as an academic study in comparison with other European states - such as the Netherlands - or the U.S.A.

117 David Ricardo, The Principles of Political Economy, (reprint - J.M. Dent & Sons Limited edition, London, 1917).

118 For an excellent exposition of the Ricardian "Law of Association", see Ludwig von Mises, Human Action, (3rd Edition, Chicago, 1966) pp 159-164.

119 The American jurist, Professor Richard A. Posner, provides a starting point for such an analysis in his book, The Economic Analysis of Law, 2nd Edition, (Boston, 1977), pp 363-385.

120 O.E.C.D., National Treatment for Foreign Controlled Enterprises, (Paris, 1985), p.24.

121 Dr. M. Widmer, IFA Seminar Proceedings, The Revised O.E.C.D. Model Double Taxation Convention on Income and Capital, Kluwer (Netherlands, 1978), Introductory Comments, p.7.

122 Given the relevant modern philosophical background - see for example G H Von Wright, The Varieties of Goodness, (London, 1963) - it is perhaps necessary to clarify the fact that the meaning and content of the adjective "good" in this context is derived from the prescriptive force of the policies and principles underlying IFL. "Good" international tax law is law which accords with those policies and principles.

123 Note 16, Ibid.

124 The description of the work of the Technical Committee is taken from Mitchell B Carroll, op. cit. at note 17 above, pp. 11 and 16.

125 Note 14, Ibid.

126 Note 17, Ibid, at p.41.

CHAPTER 2

INTERNATIONAL TAX AVOIDANCE

INTRODUCTION

The topic of international tax avoidance and evasion has been discussed by fiscal authorities and international institutions for over sixty years. The League of Nations first considered the matter in the 1920s and in the 1980s the subject remains a major concern to the O.E.C.D., the U.N., the Council of Europe and virtually all domestic fiscal authorities.

In recent years the subject has taken on a greater importance in statements, documents and books on international taxation. To some extent, the issue now dominates discussions by tax authorities relating to the development of IFL, having displaced the topic of international double taxation. This concentration on the topic of international tax avoidance is not a development which is wholly supported by tax practitioners and commentators and, as will be seen, there are some who argue that such an emphasis is misconceived.

The E.E.C. first expressed its concern about international tax avoidance and evasion in a Council Resolution of February 10, 1975.[1] Two years later the E.E.C. adopted the Directive on Mutual Assistance between the Members States' Tax Authorities.[2] In 1980, the O.E.C.D. Committee on Fiscal Affairs published a report "Tax Avoidance and Evasion" which discussed the concepts of avoidance and evasion and the measures available to combat them. In the same year the United Nations instructed its Ad Hoc Group of Experts in International Co-operation in Tax Matters to concentrate its work on tax avoidance and evasion. The matter has also been considered in the late 1980s by, inter alia, the Council of Europe[3], the International Bar Association[4], the International Fiscal Association[5] and various other bodies. This increased interest is due to a number of factors.

One suggestion is that, in the past, social and governmental sanctions have perhaps played a more effective role in deterring avoidance and evasion activities than is the case today.[6] In recent years, respect for the tax law has in general

diminished. This is presumably due to a number of factors including the increased rate of tax and perceived inequities of the various national taxation systems. This has in turn made the social and governmental sanctions less of a factor in deterring avoidance and evasion activities and therefore the potential for these activities has expanded.

The inevitable corollary of the continuing expansion of the economic and social role assumed by governments in recent decades up to the late 1980s has been the proliferation of new taxes and a continuing increase in the rates and bases of existing taxes.[7] This development has intensified the search by taxpayers for methods of reducing the tax bill and concentrated attention on tax avoidance and evasion techniques. Moreover, as the tax system has expanded and become more complex, "loopholes" have unwittingly been created, thereby providing more opportunities for tax avoidance schemes.

At the same time, tax avoidance and evasion is considered to have assumed a significant international dimension with the expansion of international trade and a huge increase in the use of international communications. This view is based on the fact that international transactions, (which involve the movement of capital, assets and people across tax borders) are likely to offer opportunities for the concealment of tax liabilities.

Furthermore the international nature of a transaction may of itself give it certain characteristics which it would not have as a purely domestic transaction. Since such characteristics may offer opportunities for the avoidance of tax, revenue authorities and legislators have in recent years considered specifically the international element of transactions.

Most domestic tax avoidance can be extended to operations across frontiers. International tax avoidance however has the additional meaning of reducing tax liabilities through the use of different tax systems, as well as different tax rates and through the migration of persons, companies or funds to achieve this end.

Another important factor in explaining the heightened interest on the part of states in international tax avoidance and evasion is their concern over the apparent loss of revenue resulting from such activities. Statistics are inevitably based on a certain amount of guess work, but it has been suggested that France loses F.Fr 30-50,000m and Belgium B.Fr. 200,000m through avoidance and evasion.[8] It has also been estimated that the U.K. loses £100M due to the opportunities that arise as a result of the special position of the Channel Islands and the Isle of Man.[9] In the U.S.A., it has been suggested that at least 10% of the total potential revenue from income taxation , U.S. $90 billion, is lost annually to tax evasion.[10]

Finally, there is a concern on the part of the fiscal authorities that if tax avoidance or evasion is allowed to prosper the result may be to undermine public acceptance of the tax system and to increase the temptation for tax payers not to comply with the tax laws or to seek artificial ways around them.

The Third Report of the United Nations Ad Hoc Group of Experts observes that:

> "The habit of fraud, once acquired, even for relatively respectable reasons, may well outlast the abnormal circumstances which fostered its creation and growth"[11]

For all these reasons the topic of international tax avoidance continues to represent to tax authorities a prominent area of concern in the wider field of international fiscal law.

TAX SAVING, TAX AVOIDANCE AND TAX EVASION

Before proceeding to the international elements of the concepts of avoidance and evasion and their significance to IFL, it is first necessary to consider the conventional definition of exactly what the concepts mean. Confusion between

the attributes of avoidance and evasion is notorious[12] and the situation is hardly helped by the recent introduction of the term "avoision".[13]

The concepts of avoidance and evasion cover a wide spectrum of activity to reduce or remove tax burdens.

The conventional view distinguishes three categories; tax saving, tax avoidance and tax evasion. The extent to which these categories are useful analytical tools for IFL will be discussed later in this chapter. However, this conventional categorisation is recognisable to a greater or lesser extent in many countries.

Tax Saving

The term "tax saving" is used to describe activity by the taxpayer in an area of behaviour which is not officially considered to be of any fiscal relevance. It may, in practical terms, be thought of as occurring when a taxpayer "sidesteps" a liability to tax as when, for example, he refrains from working and thus avoids income tax or when he refrains from selling certain of his assets, thus avoiding a capital gains liability. Tax saving in this sense is recognised as a legal and wholly legitimate form of behaviour.

> "It is possible to reduce or remove tax liability... by refraining from consuming a taxed product and it is clearly not the intention of the Working Party [of the O.E.C.D. Committee on Fiscal Affairs] to combat activities of this kind".[14]

Tax Avoidance

There exist a number of suggested classifications and definitions of the concept of "tax avoidance". Professor Arthur Shenfield, in the Political Economy of Tax Avoidance[15], classifies avoidance into the following four categories:

(i) The decision not to acquire capital or accept taxed employment, etc. taken in order to avoid tax;

(ii) The acceptance of tax exemptions, tax privileges or tax holdings offered by a government.

(iii) The pursuit of normal commercial objectives, but with an eye to the selection of that method which provides the least unwelcome tax result.

(iv) The pursuit of tax avoidance as the main or sole aim of a transaction.

Shenfield's first category describes tax saving as opposed to tax avoidance as it is normally understood. This illustrates an alternative view of regarding "tax avoidance" as a wide concept embracing all forms of reducing tax liability other than those within the concept of tax evasion. However, it is considered that the separate categorisation of "tax saving" with the consequent more restrictive scope of the concept "tax avoidance" corresponds to normal usage.

While Shenfield approaches the definition of avoidance by explaining the categories it may be reduced into, Professor G.S. Wheatcroft, in an article entitled "The Attitude of the Legislature and the Courts to Tax Avoidance"[16], approaches the definition by analysing the constituent elements of avoidance. Wheatcroft describes tax avoidance in general as "the art of dodging tax without actually breaking the law". More precisely, he defines it as follows:

> "First of all, tax avoidance must be distinguished from tax evasion. Avoidance is legal; evasion illegal... Motive is also an essential element in tax avoidance. The man who deliberately adopts one of several possible courses must be distinguished from the man who adopts the same course for entirely different reasons. A tax avoidance transaction is one which would not be adopted if the tax-saving element had not been present"[17]

Wheatcroft also argues that the intention of the legislature must be taken into account because the legislature acts in a way which encourages or discourages certain practices. In summary, Wheatcroft defines tax avoidance as a transaction which:

(i) Avoids or reduces tax;

(ii) Is entered into for the purpose of avoiding tax, possibly involving some artificial or unusual commercial form;

(iii) Is carried out within the law; and

(iv) Is not a transaction which the legislature intends to encourage.

Whilst this is an adequate statement of the principal elements of the conventional view of tax avoidance, there are a number of problems, both conceptual and practical, with this definition. For example, test (iv) above depends in part on construing the intention behind the law yet this is a notoriously difficult exercise. These problems are discussed more fully below, after the conventional notion of tax evasion has been considered.

The distinguishing feature between tax saving and tax avoidance is the relevant legislative intent. This is clearly the distinction adopted by the O.E.C.D.:

> "Those activities which fall within the scope of what is here called "tax avoidance" include schemes or arrangements which attempt to reduce tax liability to a level below that which the Government intended should apply to that particular income in those particular circumstances"[18]

In the case of tax avoidance, the taxpayer moves in an area of behaviour which the legislator intended to regulate but somehow failed to bring under control (for

example, through defective drafting). Therefore, although the tax liability may be reduced by methods which are within the strict letter of the law, the circumstances of the reduction are such that it is felt that the underlying intention of the tax legislation would be to impose a charge to tax.

Tax Evasion

Tax evasion may be defined briefly as follows:

> "Action by the taxpayer which entails breaking the law and which moreover can be shown to have been taken willingly with the intention of escaping payment of tax"[19].

Although the payment is evaded, the tax liability is not. Examples of tax evasion are: failure to notify the tax administration of activities giving rise to taxable income, the use of fraud to claim tax allowances which are not legally due, etc.

The conventional view is that there are two elements to the definition of tax evasion. The objective element consists of the existence of specific circumstances which afford the taxpayer the opportunity of evading, in whole or in part, the payment of tax. The subjective element consists of a deliberate intent to defraud.

However, in defining whether tax has been evaded it is not always necessary to show that the taxpayer has acted in bad faith. Tax may be evaded in some cases by, for example, the failure to submit a tax return by a certain date, irrespective of the intention of the taxpayer.[20] In such a case the defect may be due to the taxpayer's negligence or his failure to exercise proper care. Therefore tax evasion does not invariably involve the subjective element of a "wilful" act by the taxpayer.

The Committee on Fiscal Affairs of the O.E.C.D. has observed that "within tax evasion proper a distinction is sometimes made between the less serious offence

of omission, e.g., failure to submit complete returns of income, and more serious offenses, such as false declarations, false invoices, etc".[21]

The term "tax evasion" also describes what is often referred to as the "black economy", which involves jobs and income which are not disclosed to the fiscal authorities.

The Conventional View Considered

The next section considers the extent to which the concepts of tax saving, tax avoidance and tax evasion can be utilised in discussions of IFL. By way of preliminary, this section considers briefly the coherence of the conventional categorisation and a number of problems are explained and discussed.

The distinction between tax saving and tax avoidance depends solely on the "legislative intent". Only if the legislator intended to regulate a particular area of economic activity, but somehow failed, is activity within the area of tax avoidance rather than tax saving. The criterion of "intention" alone is unlikely to provide a sound basis for this distinction. There is the obvious difficulty in determining the precise intention behind the legislation. Even if this is possible, many legal systems discourage or do not permit the introduction to the judicial process of evidence relating to the original intention.

For example, in the U.K. there exists the "Hansard Rule" which arises from judicial decisions extending back over two hundred years.[22] Under the Rule, Hansard and other similar sources cannot generally be reviewed by the courts. The Rule was referred to by Lord Reid in the case of Beswick v. Beswick:

> "In construing any Act of Parliament we are seeking the intention of Parliament and it is quite true that we must deduce that intention from the words of the Act... For purely practical reasons we do not permit debates in either House to be cited".[23]

The intention of a statute is therefore inferred rather than investigated:

> "... but we can only take the intention of Parliament from the words which they have used in the Act, and therefore the question is whether these words are capable of a more limited construction. If not, then we must apply them as they stand, however unjust and unreasonable the consequences and however strongly we may suspect that this was not the real intention of Parliament".[24]

A recent U.K. commentator is well aware of the difficulties:

> "I am often unable to understand "Parliament's intent", and I should be more inclined to consider the fault as mine rather than Parliament's were it not for incidents like the occasion when the Attorney-General, introducing a piece of anti-avoidance legislation, spoke to a brief for a different clause and subsequently apologised for his mistake, none of the Members present having noticed the difference. The same Minister can claim another distinction. In introducing another piece of anti-avoidance legislation he gave an assurance to Parliament about the limitation of its scope. In the fullness of time a case was brought under the section concerned and found its way to the House of Lords, where the Lord Chancellor supported the opposite interpretation to the one he had put before the Commons as Attorney-General."[25]

A further difficulty is that intention, by definition, applies only to those facts or circumstances which are foreseen. Where a wholly new situation arises and this situation was clearly not foreseen by those who originally framed the relevant tax law (which may or may not apply to it), it hardly makes sense, in dealing with this new situation, to consider what the intention of the legislation is.

If the criterion of "intention" is unreliable, the concept of avoidance is obviously unclear and it is invidious to expect the taxpayer to respect - or even understand - the distinction between tax saving and tax avoidance and therefore refrain from the latter.

Similar problems arise if the motive of the taxpayer is taken as one of the defining elements of tax avoidance. It will often be extremely difficult to identify the particular motive of a taxpayer in taking a certain course of action and the problem is significantly exacerbated where there are a number of motives of a mixed kind. For example, a commercial decision may be made in order to achieve commercial, fiscal and social goals. It is difficult to see how a court can disentangle these motives and quantify the weight to be attached to each particular factor.

There are many situations in which arrangements may be made to minimise a tax burden. Some may be tolerated by governments and fiscal authorities whilst others may be attacked relentlessly. There appears to be a view that there exists some sort of boundary between using artificial or blatant avoidance devices ("unacceptable" tax avoidance) and between simply taking advantage of the tax legislation by so arranging one's affairs as to avoid the maximum incidence of taxation ("acceptable" tax avoidance).

It is of course possible to regard all these methods of reducing tax as avoidance activities, but it is difficult to draw a distinction between arrangements which are condoned by the fiscal authorities and those which are not. If there exists a distinction between "acceptable" tax avoidance and "unacceptable" tax avoidance it is not clear how this distinction is to be drawn.

The distinction has been described as one of common sense.[26] However, John Tiley is surely right in observing that the distinction:

> "... is also one of degree rather than kind and the cynic would classify other people's devices as artificial and the speaker's own as legitimate. This imprecision is undesirable not only because it causes uncertainty in the administration of the law, but also because of the consequences of that uncertainty, with variations in the exercise of any discretionary power, resentment where taxpayers receive different treatment and the dangers of maladministration...".[27]

The arbitrariness of the situation is underlined by the fact that in some countries the legislation simply gives to the fiscal authorities the power to decide what constitutes avoidance in a wide range of situations without the obligation to provide criteria or guidelines in advance.[28]

The use of words such as "unacceptable" or "improper" suggests there exists an underlying moral element to the issue of international tax avoidance.

It is no answer to explain avoidance or the attitudes taken to avoidance by the fisc by reference to concepts of what is moral since, on any rigorous analysis, this merely relocates the problem in the realm of esoteric moral philosophy. Moreover, if evasion, and perhaps avoidance, is morally culpable, this may lead to the conclusion that the only morally acceptable conduct in tax matters is to <u>maximise</u> the tax bill. This is unlikely to be accepted by the vast majority of taxpayers nor by sections of the judiciary.[29] Moral considerations are, in any event, not a key factor in the debate:

> "We suspect that moral considerations are less important in tax enforcement than in any other single part of the law".[30]

The O.E.C.D. takes a similar line in stating that it is not desirable for tax authorities to take a moral attitude towards tax avoidance:

> "In combatting tax avoidance the tax authorities, in their official capacity, are simply administering the law in accordance with what they understand to have been the intention of Parliament, or in other words, the purpose of the law".[31]

Turning to the distinction between avoidance and evasion, here, too, there are difficulties in supporting the distinction. Certain types of (as it appears) avoidance schemes are treated in fact more like tax evasion and the opprobrium traditionally reserved for evasion is now frequently attributed to arrangements for the avoidance of tax.

Economically, avoidance and evasion are hardly distinguishable since it is of minimal importance economically whether a particular activity or transaction falls within the law or not. Legally, the distinction is, at the very least, blurred at the edges. An example will illustrate the difficulty: if a U.K. company pays a management charge to an overseas company in respect of non-existent services, this is clearly evasion. If, however, the overseas company does provide management services but the charge is slightly above the comparable market rate in relation to the services provided, the reduction in the U.K. tax liability of the U.K. company is attributable to avoidance. If the fee charged by the overseas company is manifestly excessive in relation to the services performed, the position is less clear. Both companies are of course entitled to enter into whatever contractual relationship for the provision of management services they wish. However, there may come a point where the fee is so disproportionately large and the service so minimal that the genuine nature of the transaction must be called into question. In such a case the question as to whether the arrangement constitutes evasion must surely arise.

THE INTERNATIONAL DIMENSION

The last section has demonstrated that there are certain problems with the conventional categorisation of tax saving, tax avoidance and tax evasion. However, although the distinction between tax saving and tax avoidance does not appear to be tenable, the distinction between avoidance and evasion has been shown to be blurred at the edges rather than totally useless.

The question which now falls to be considered is the extent to which the concepts of avoidance and evasion can be used by IFL as analytical tools for classifying tax minimising behaviour.

The concepts are utilised by the United Nation's Department of International Economic and Social Affairs[32] and in a number of other books and publications addressed to an international audience which deal with matters affecting IFL.[33] This, presumably, suggests the concepts have a significance for IFL.

However, a closer analysis indicates that there may be difficulties in applying the concepts in this general way to IFL. There is the immediate difficulty of terminology - Germany, for example, uses the term "Steuerflucht" (literally, tax flight) for avoidance and the term "Steuerhinterziehung" for evasion, whilst the French use "evasion" for avoidance and "fraude fiscale" for evasion.

The difficulty is not purely semantic. For example, from a purely linguistic point of view, the Swedish terms "skatteflykt" and "skatteundandragande" seem to be rather exact translations of "avoidance" and "evasion".[34] However, neither these words nor anything like them feature in the Swedish language to denote actions leading to a reduction in tax. In practice, the courts have decided, in cases where a certain action by a tax payer has led to a reduction of his tax liability, that the action has been accepted or not accepted for tax purposes without using the words "skatteflykt" or "skatteundandragande" or any other expression indicating an action leading to a reduction of tax. Obviously, this makes the definition of the

terms "avoidance" and "evasion" for the purposes of Swedish law highly problematic.

Although the general distinction between evasion and avoidance is recognisable in many legal systems, in some countries the difference between tax saving and tax avoidance is not established. This must mean that such countries attribute a different all embracing meaning to the concept of avoidance as compared with those countries which make the tax saving - tax avoidance distinction. In Japan, for example, tax avoidance includes the generally accepted range of "tax saving".[35] Theoretically, it might be possible simply to expand the concept of tax avoidance to include "tax saving". In practice, however, there would still remain the disparate senses of avoidance and evasion. Taking Japan as an example again, Hiromitsu Ishi, Professor of Economics, Hitotsubashi University, Tokyo, has recently characterised the activity of treaty shopping as evasion whereas it is more normally considered an avoidance activity.[36]

The problem is not isolated to this one instance. As the U.N. Department of International Economic and Social Affairs has observed:

> "Additional problems may arise..... because of the variations in legal standards from country to country; a course of action which is clearly illegal in one country may fall within an ambiguous "grey area" in another".

The attitude to transfer pricing practices is a case in point. In most countries, transfer pricing techniques are viewed as avoidance activities. Yet, in Greece, Brazil, Argentina and Italy all non-arm's length transactions are viewed as evasion, no matter how they are accomplished.

A further point can be made in connection with such avoidance mechanisms as transfer pricing: avoidance may be judged legal or not by reference to the effects it may have on exports. In France, for example, the arms length criterion does

not apply if the resident company can demonstrate that the abnormality of the price results in increased exports or in an expansion of the company's activities in foreign markets.

Moreover, some jurisdictions deny a legal meaning to the term "avoidance". There are two possible grounds:[37]

(i) Where only tax evasion is punishable, activities that might otherwise be called "avoidance" are fully legitimate and the term "avoidance" is thus legally immaterial.

(ii) Where avoidance activities may be penalised, the term "avoidance" is immaterial because any illicit avoidance would be legally labelled as evasion which in the legal tax code includes all violations of tax laws.

Therefore, only certain countries recognise any legal significance in the concept of "avoidance". Even where it is recognised, there may also be problems in the concept of avoidance. In Canada, for instance, certain activities are regarded by the fiscal authority, Revenue Canada, as constituting proper tax planning and therefore legitimate tax avoidance whilst other arrangements are viewed as constituting improper tax avoidance. The line between the two cases is not always clear. Where circumstances are found to amount to improper tax avoidance, a taxpayer's tax liability will be reassessed and in some cases a financial penalty of 25% of the tax improperly avoided plus interest charges will be imposed.[38] Such penalties are more normally associated with evasion activities and indicate the very close similarity in the Canadian jurisdiction between evasion and improper tax avoidance.

Similarly in Australia, the present national climate vis a vis tax avoidance is to place it somewhat on a level with tax evasion:

> "In the current climate however, no attempt at a distinguishing definition [between avoidance and evasion] could successfully be made".[39]

The concept of evasion also varies from jurisdiction to jurisdiction. Evasion constitutes a criminal offence in some but not all countries. In some jurisdictions the specific intent of the taxpayer to evade taxes leads to a particular form of tax evasion, namely tax fraud. Whether evasion is also tax fraud can be very significant. For example, under the Swiss Federal Law on International Mutual Assistance in Criminal Matters legal assistance will be accorded by Switzerland only if the matter of the proceedings is a tax fraud and not a mere "evasion" according to Swiss terminology.[40] Similarly, under the European Convention on Extradition (Protocol), extradition under the law of the requested state can take place only where the fiscal offence corresponds to a violation of the same nature.[41]

Evasion does not require intent on the part of taxpayer in all jurisdictions where it is recognised as a legal concept. In Austria, Greece, Luxembourg, Norway, France, Denmark, Switzerland, Israel and Italy, evasion does not generally require an intention to evade on the part of the taxpayer, though intention to evade is a pre-requisite to establishing a criminal offence.[42]

Usually, non-intentional evasion gives rise to the payment of interest on the additional tax levied by the fisc and no penalties are imposed.

In other states intention is required for evasion. In Canada, for example, tax evasion is specifically defined under the Income Tax Act of Canada.[43] In the view of Revenue Canada, tax evasion means;

> "the commission or omission of an act knowingly with the intent to deceive so that the tax reported by the taxpayer is less than the tax payable under the law, or a conspiracy to commit such an offence"[44]

The Spanish Parliament has recently approved an amendment to the law on "tax infractions" which permits punishment even in the case of simple negligence,[45] whereas in other jurisdictions, such as the U.S.A., civil and criminal fraud penalties can be imposed only where there is a finding of wilful intention to evade on the part of the taxpayer.

In the light of these numerous differences in the approach to evasion by fiscal authorities, it is no surprise that the International Fiscal Association observed in its 1983 General Report on Tax Avoidance and Tax Evasion that:

> "The survey of countries under review emphasises the impossibility of establishing common criteria or underlying concepts with any reasonable degree of certainty".[46]

International institutions have made similar observations. The O.E.C.D. has stated that although the tax avoidance-tax evasion distinction is frequently made, it is in reality:

> "impossible to make this distinction in any consistent way as between countries. Not only do tax laws differ, but to frustrate the intentions of the law is, in some countries, already to break the law, so that in such countries there is no clear-cut distinction between tax avoidance and tax evasion".[47]

Recent thinking, therefore, suggests that it is misconceived to apply the concepts of avoidance and evasion, however they may be defined, in the field of IFL. The attempt to provide an internationally acceptable distinction between them is probably futile.[48] Instead the trend appears to be to talk in terms of particular avoidance schemes. This trend is reflected in the discussions of the leading international institutions concerned with international fiscal policy. For example, this trend appears to be confirmed by the implicit conclusion of the Report by the O.E.C.D. Committee on Fiscal Affairs, "Tax Evasion and Avoidance".[49] The

Report was produced to set out the scope of activities which would be considered in O.E.C.D. Member countries as falling within tax evasion or avoidance. The Report also considers legal and administrative positions regarding anti-evasion and anti-avoidance activity.

No common definition of "tax evasion" could be agreed upon:

> "The Working Party began by setting out to see whether, by collecting examples from the experience and practice of member countries, it was possible to reach a common definition of the scope of "evasion"... No single text proved to be fully satisfactory..."[50]

The Working Party came to much the same conclusion in the case of "avoidance", noting that the scope of what is considered tax avoidance varies from country to country, depending not only on the form a particular transaction may take but also on attitudes of governments, parliament, public opinion and the courts, which may themselves change within one country over time.

In spite of these statements the Working Party concludes:

> "... but this does not imply that O.E.C.D. governments are not generally in agreement on what constitutes the range of tax evasion and avoidance they wish to combat or that they have problems in identifying it"[51]

This conclusion is somewhat confusing. If common agreement cannot be reached on the concepts of avoidance and evasion, it is difficult to see how O.E.C.D. governments can be "generally in agreement on what constitutes the range of tax evasion and avoidance they wish to combat".

The answer seems to be that tax authorities and international organisations are now beginning to single out and attack individual avoidance schemes which are

considered unacceptable and they are now less concerned where such schemes fit into the traditional categories of avoidance or evasion. This means that although there is no prospect of a common international agreement on what constitutes tax avoidance or evasion, there may be such a consensus on the types of activity that the fiscs will seek to oppose. This type of approach, under which a concern over the nature of - and distinction between - avoidance and evasion is relegated in favour of a concern focused on particular types of activity, is a development which can be identified in various states.[52] However, it is also clear that this development has taken place on a much broader footing and is reflected in the work of the leading international fiscal organisations. This is made clear by, for example, the stated purpose of the O.E.C.D. report referred to above:

> "... in particular to show why certain activities and arrangements, even though those who have recourse to them try to keep within the letter of the law, cannot be tolerated by governments or by tax administrations who have to administer tax legislation"[53] [emphasis added].

The type of avoidance schemes under attack will, according to the O.E.C.D. Committee on Fiscal Affairs, typically have the following characteristics:

> "the main feature is that there is an attempt to reduce tax liability to a level below that which the legislature intended....almost invariably there is present an element of artificiality or, to put this another way, the various arrangements involved in the scheme do not have business or economic aims as their primary purpose....Secrecy may also be a feature of modern avoidance....Tax avoidance often takes the form of taking advantage of loopholes...."[54]

The U.N. Department of International and Economic Affairs has also come to a similar conclusion.[55] No attempt is now made to give a definition, as such, to

"unacceptable" international tax avoidance as a generic phenomenon. Instead, international agreement is beginning to evolve amongst fiscal authorities on particular issues.

Perhaps the first example of this is in the area of transfer pricing practices, which were very widely debated in the mid 1970s. A similar approach to this method of international tax avoidance is now taken by many fiscal authorities. Topics which have been singled out more recently include treaty shopping and thin capitalization.[56]

The United Nations has recently noted that "it would be desirable... to achieve some international consensus on which practices of taxpayers could be regarded as acceptable or not".[57] This, it is assumed, is precisely what is intended to happen when a body of international agreements between tax authorities on particular issues has evolved: it is presumably intended that such a consensus will contribute to the evolving principles of IFL and determine what activity is or is not acceptable in the international sphere. This approach is not without its own difficulties.

If there is a shift away from an analysis in terms of avoidance and evasion toward an analysis which considers whether behaviour is acceptable or unacceptable, where the criteria of "acceptable" are set by the fiscal authorities, then it becomes more difficult for the fiscal authorities to defend themselves from the charge that their criteria are arbitrary and that their whole approach has no conceptual foundation or justification. Therefore, the tax authorities are still left with the problem of explaining <u>why</u> the particular behaviour or activities they are opposing are unacceptable. It is not sufficient for them merely to describe the characteristics of "unacceptable" tax avoidance, as has so far been done. What is required is a statement of the criteria applied to determine "unacceptable" behaviour and an explanation of the assumptions on which those criteria are based.

This point is of relevance to the discussion of equity in the last chapter. As is explained further in the following section below, anti-avoidance legislation is very often justified by reference to the need to restore fairness amongst taxpayers, the argument being that the avoider is side-stepping his fair share of the tax burden properly due to the state or states concerned. An argument along these lines clearly makes certain assumptions about the nature of "fairness" (or "equity") and certain of these (which are economic considerations) are discussed in the next section below. For the present, however, it should be noted that what is fair or equitable as between taxpayers - or indeed as between states - must, in a fiscal context be a function of the relevant rules. In the present context the relevant rules are the rules - or principles - of IFL. Thus, for example, (and subject to the comments on economic considerations which follow below) it may be argued that a taxpayer who is carrying on abusive transfer pricing practices offends against this requirement of fairness or equity because of his breach of the relevant rule of IFL. This rule is the arm's length standard, as enacted in domestic legislation and double tax treaties.[58] As a result of this breach, the offending taxpayer may be said to be violating the equity principle as regards his fellow taxpayers in the state which is losing the revenues which would otherwise be generated. That state may itself also take the view that there is a breach of the equity principle as between it and the state which, as a result of the abusive transfer pricing practices, is benefitting from increased taxable revenues. It is in this sense that matters of fairness or equity are relevant to the debate on international tax avoidance. However, it should be stressed that considerations of equity do not entitle states to impose <u>any</u> constraint or charge on taxpayers in the name of combatting international tax avoidance. As stated above, if particular activities or transactions are regarded as "unacceptable" an indication of the criteria or reasons behind that judgement should be forthcoming and those criteria or reasons should be consistent with the policies and principles of IFL.

The criteria which the tax authorities will seek to apply are unlikely to be simply those of IFL which were discussed in Chapter One: IFL sets out, inter alia, to <u>limit</u> the competing claims of the fiscs where this is necessary to achieve the

primary goal of IFL (the avoidance of international double taxation). The tax authorities, on the other hand, have the quite different objective of levying taxes in order to raise revenue and they are normally anxious to raise as much revenue as possible. It would therefore be somewhat unrealistic to expect them to prioritise the goals of IFL quite without regard to their own objectives. However, for the reasons discussed in Chapter One, it is essential that in raising revenue, the fiscs attempt to conform to the requirements of IFL (i.e. avoiding double taxation, applying equitable and neutral taxation, etc).

It is in this context that the approach of the fiscs to combatting international tax avoidance is to be appraised. Therefore, whatever anti-avoidance measures are adopted must not in themselves create double taxation and they should be as neutral and as equitable in effect as possible. As will be demonstrated later in the context of the discussion on the U.S. and the U.K., the tax authorities recognise and accept these general points.

The opposition of the fiscs to international (and domestic) tax avoidance is grounded on their primary objective of raising revenue, the assumption being that there is a clear relationship between the prevention of avoidance and the collection of taxes. It is, therefore, this assumption which underpins and justifies the emphasis of the tax authorities on combatting international tax avoidance. The assumption is considered further in the next section.

ECONOMIC CONSIDERATIONS

It should perhaps be emphasised that this thesis is concerned with policy and legal issues not with economics. There is therefore no intention whatsoever to justify the discussions or arguments in this thesis by reference to economic considerations.[59] However, the economic goals which it is assumed underlie the levying by states of taxation (being, primarily, the raising of public funds) are clearly relevant to the discussion in this thesis, especially as the phenomenon of international tax avoidance is normally regarded as an economic issue.

It has been demonstrated that international tax avoidance is perceived by most fiscal authorities as a very significant problem. The official literature on the subject is full of references to international tax avoidance as, for example, a "violation of fiscal equity" and a side-stepping of the "fair amount" of tax due, resulting in a larger amount of tax being levelled on the "honest tax payer".[60] For example, the Committee on Fiscal Affairs of the O.E.C.D. has stated that:

> "The revenue loss from the proliferation of tax avoidance devices is assuming serious proportions and it is the taxpayer refraining from avoidance who has to foot the bill, whether in terms of higher taxation or reduced social welfare benefits or other public services.[61]

Similarly, the recent New Zealand Consultative Document on International Tax Reform states:

> "... some residents... are avoiding tax on their foreign income, some of which is income that is diverted from New Zealand. This places an unfair burden on others and undermines the integrity of the tax system... It is overwhelmingly clear that the New Zealand tax base must be protected from international tax avoidance... Reductions in tax avoidance and lower rates of tax go hand in hand".[62]

Such statements reflect the traditional wisdom on the subject.

There is an alternative view, however, which stands this conventional wisdom on its head, suggesting that the current analysis is grounded on mistaken assumptions. Dr. Barry Bracewell-Milnes is the chief exponent of this view but not its only proponent.[63] His argument is most clearly stated in his books Tax Avoidance and Evasion: The Individual and Society, The Taxation of Industry and The Economics of International Tax Avoidance.[64] The central theme is that the tax avoider may well confer gains rather than losses on both fellow taxpayers and the fisc. This is clearly something of a revolutionary thesis. If correct, it would make a significant

impact on current debates on international tax avoidance in particular and the development of IFL in general. This is because the initiatives and measures directed against international tax avoidance generally assume that such avoidance is an economically undesirable phenomenon.

The arguments propounded by Dr. Bracewell-Milnes appear to have been largely ignored by the international institutions where the fiscs meet to discuss international tax avoidance (e.g the U.N. Group of Tax Experts, the Council of Europe and the O.E.C.D. Committee on Fiscal Affairs) and they have do not seem to have been widely discussed by other commentators. It would be unfair to regard this as a reflection on the quality of the arguments themselves; as far as this writer is aware, there exists no comparable counter-argument, nor even an attempt at one. Instead, activity in suppression of both domestic and international tax avoidance continues without serious consideration of the assumptions and constraints of anti-avoidance efforts by the fiscs and their supporters.

However, Dr. Bracewell-Milnes analyses and criticises this universal assumption by fiscal authorities that pursuit of tax avoidance is correct without any need for justification:

> "The economic argument that the avoider is adding to the burden on his fellows depends on at least three doubtful assumptions; first, that incentive effects are negligible (otherwise the avoider who increases his own prosperity may thereby increase the prosperity of his fellows); second, that the Government spends money more efficiently than private persons, even after allowance for costs of administration (otherwise prosperity can be increased by transfer of resources, through avoidance, from government to private persons); and third, that government spending is determined independently of income (otherwise any additional tax revenue may simply be absorbed in additional government spending) and this additional

> government spending may be of little use or even worse than useless in increasing prosperity"[65]

In rebutting the assertion that avoidance activities are selfish whereas tax paying is public-spirited, Bracewell-Milnes refers to the general theme of the Wealth of Nations, namely the harmony between individual selfishness and the public interest: Adam Smith showed that, in a liberal order, a citizen best serves his fellows by serving himself.[66]

Bracewell-Milnes thus takes the view that conventional anti- avoidance measures reduce avoidance only by increasing evasion. This is because "avoidance and evasion are competitive with each other; the more the avoidance, the less the evasion, and vice versa".[67] This inevitably means that "there are diminishing returns to anti- avoidance and to other expressions of hostility by the fisc; the more hostile the attitude of the fisc, the more hostile the attitude of the tax payer".[68]

The consequence of this is that anti-avoidance legislation will only be effective in the short term or where it has retrospective effect.

Bracewell Milnes suggests there is also the further danger anti-avoidance measures can actually lead to an <u>increase</u> in avoidance (and evasion) activities:

> "Anti-avoidance and anti-evasion have something in common with attempts to put down civil commotions. They may propagate the disorders they were intended to suppress. They may increase resistance either <u>extensively</u> (by attracting more supporters to the cause) or <u>intensively</u> (by deepening the will to resist). Majority support is not enough to secure the suppression of riots or other political disobedience and majority support is not enough to suppress taxpayer resistance. The term <u>disaffection</u> is appropriate to both. It is chargeable taxpayers (the taxpayers liable to taxes in

> question) - perhaps only a minority of the population - where affections need to be won back if the political and moral costs of enforcing compliance are not to be unacceptably high".[69]

This view is not without some support, as is indicated by the following observation in a communication from the European Commission to the European Parliament:

> "Moreover, the close link between honesty on the part of taxpayers and their level of taxation cannot be denied. Taxpayers, indeed, have much less recourse to evasion and avoidance when they consider their level of taxation to be fair and reasonable..."[70]

Developing the economic argument, Bracewell-Miles states:

> "Hard core tax avoidance is the most beneficial not only to the outsider but also to his fellows not only in the taxpayers' interest but also in the interest of the economy and society. The harder the better; the more artificial the taxpayer's constructions the less the fiscal distortion of economic activity.[71]

The basis for this proposition is the fact that the incidence of taxation causes shifts or switches in economic activity and therefore results in inefficient distortions. The more formal and the less substantial the switch in economic activity the less the economic damage it causes and hence the preference for hard-core or "highly artificial" avoidance. Bracewell-Milnes criticises the anti-avoidance lobby for ignoring the shifting of activity that anti-avoidance legislation causes, especially when such legislation is levelled primarily at artificial constructions (which result in tax avoidance without the shifting of activity) from which other taxpayers gain. Tax saving, on the other hand, which is equated with "avoidance by inactivity" (not earning, not saving etc.) is invariably damaging for the fisc and the rest of the taxpaying community as a whole, yet it is not criticised by the fisc at all.

Bracewell-Milnes also argues that tax avoidance may be beneficial by the effects it has of increasing economic activity either directly or by increasing savings. For example, where tax rates are high, avoidance may benefit the fisc by maintaining the incentive to activity that would otherwise be frustrated by taxation.

As a result of this, "It is concluded that the avoiding taxpayer may confer gains instead of losses on his fellows, including the fisc".[72]

According to the argument, avoidance can actually increase the yield of a tax and thus benefit the fisc where the rate of tax is beyond the point of maximum yield - the avoidance of part or all of such a tax may increase the yield not merely of the whole tax system but even of the tax avoided.[73] The argument is arguably supported by empirical as well as theoretical evidence:

> "The maximum marginal rate of taxation will be reduced from 65% to 50%. It is expected that the reduced temptations for avoidance and evasion due to a lower rate will lead to an increase in tax collections through greater compliance with the law.[74]

For all these reasons, a case can be argued for saying that "avoidance and even evasion may ..... be a form of "public service" in consequence if not in motive".

Bracewell-Milnes theme can be summed up by stating his view that tax avoidance (and evasion) are in general not less likely to help than to harm the taxpayers' fellows and that "artificial" and forbidden methods of avoidance are in general more likely to benefit the taxpayers' fellows than "natural" and permitted ones, since the former have a less distorting effect on economic activity. In short, the market is the most efficient system for serving the individual and society:

> "In so far as tax avoidance reduces the burdens on other taxpayers or at worse leaves them unchanged, the arguments against avoidance on moral grounds lose much of their force"[75]

By reference to the conventional view of the subject referred to above, it is clear that the views of Bracewell Milnes are controversial and might be regarded as somewhat extreme. Nonetheless, it is evident that economic arguments have not been adequately considered in discussions on international tax avoidance. For example, even if much of the thesis propounded by Bracewell Milnes is rejected, it would still seem important to consider the important distinction highlighted by Bracewell Milnes between, on the one hand, activities by the fisc which raise revenue and, on the other, activities by the fisc which combat avoidance but do not raise revenue. It seems equally clear that the analysis of the phenomenon of international tax avoidance should logically start with value-free (or "positive") economics; i.e., in what situations is the fisc more likely to gain revenue from international tax avoidance and in what situations is it likely to lose. The determination of these questions is logically prior to discussions relating to the appropriate type of anti-avoidance legislation in any particular case. This is because the fisc has as its goal an economic objective, to raise revenue through the taxation system.

The wider economic perspective, and particularly the proposition that avoidance activity may benefit both taxpayers and the fisc, is potentially of considerable significance to discussions relating to the development of IFL. However, this thesis is not concerned with these economic arguments in any greater detail and, again, it should be emphasised that no reliance or justification is placed on these economic considerations beyond some very simple points. These are that economic considerations appear to have been largely ignored in the approach of the fiscs to international tax avoidance, that this seems illogical given the economic nature of the central objective of the fiscs and, finally, that there are suggestions that the assumptions made by the fiscs in connection with international tax avoidance are in any event false.

This suggests that, judged solely in terms of the goal of the tax authorities to raise revenue through taxation, the concentration of efforts on combatting international tax avoidance may be misplaced. If this is the case, the efforts of the tax

authorities would be more productive in revenue raising terms if diverted elsewhere, perhaps to the clarification or development of legislation to deal with problematic transactions. This point can be illustrated by reference to the consideration by the U.K. Inland Revenue of possible anti-avoidance legislation aimed at thin capitalization. A number of representations were made to the Revenue on this topic and a large proportion suggested that such legislation was not necessary and would probably do more harm than good in revenue-raising terms. A representative of The Institute of Directors made the following point:

> "My Committee also wishes to express its concern that scarce staff resources at Somerset House are being devoted to this topic, when the much more fundamental question of exchange differences remains unresolved. We... once again urge that the subject is given the staffing and legislative priority it deserves".[76]

There are therefore grounds for fearing that the approach of the fiscs to international tax avoidance may be of little use, or even counterproductive, in securing their own objective of raising revenue. Further, in view of the earlier discussion which suggested the apparent lack of criteria to justify the current "piecemeal" approach to fighting what is perceived as international tax avoidance and which also suggested that the combatting of international tax avoidance has now displaced the topic of international double taxation as the top priority of the tax authorities, there is a danger that the development of IFL is being arrested, and perhaps distorted, quite unnecessarily.

The above comments emphasise the need for a clear analysis of the phenomenon of international tax avoidance. Other points suggest the same conclusion. For example, the U.K. portion of the 1980 O.E.C.D. Report by the Committee on Fiscal Affairs entitled "Tax Evasion and Avoidance"[77] is somewhat dismissive of the definitional problems attaching to the concept of avoidance and comments:

"It is difficult to describe an elephant, but we recognise one when we see it".[78]

Not only is the attempted analogy rather poor (an accurate description of an elephant can easily be given), but the implication of the statement itself is not correct: one of the major reasons behind the difficulties attaching to the concept is precisely the lack of any broad agreement as to what constitutes avoidance.[79] The difficulties are illustrated by the renowned Hoffman La Roche controversy which led to considerable public discussion following a Monopolies Commission Report on the matter.[80] In that case, the profits accruing to a U.K. subsidiary from the sale of two newly discovered drugs, librium and valium, were approximately £3 million, whilst it was calculated that the total group profits on the same sales amounted to £27 million, the other £24 million coming from the mark-up on sale between the parent company and the U.K. subsidiary. As a result of the investigation, Hoffman La Roche was compelled to reduce its prices in the U.K. (which were already amongst the lowest in the world). The Inland Revenue also became interested in the matter and took the view that the transaction amounted to tax avoidance.[81] However, it was argued that a very high transfer price was necessary in order for the parent company to recoup large research and development expenditure incurred in previous years. It was also pointed out that, despite enormous research costs, only one out of five thousand products it developed was likely to be a commercial success. In these circumstances it is not clear that the arrangements entered into by the group were other than sensible commercial practice. It is submitted that the case indicates the difficulties of identifying tax avoidance activities in the absence of a clear explanation of what is tax avoidance activity. As such, there are further grounds for doubting the benefit of the recent trend of the tax authorities of identifying the particular activities which are deemed unacceptable instead of setting out the reasons why such activities are opposed.

Tax havens, in particular are associated with the phenomenon of international tax avoidance[82] and their existence raises further problems which require to be

considered. However, before proceeding to consider the subject of tax havens in the next chapter, it is first necessary to set out the measures and approach normally adopted by tax authorities in opposing international tax avoidance. This matter is dealt with in the next (final) section of this chapter.

MEASURES AGAINST INTERNATIONAL TAX AVOIDANCE

International tax avoidance may be combatted either by unilateral measures adopted by states separately or by bilateral or multilateral measures adopted by states acting in concert. Unilateral measures remain the more commonly used means adopted by fiscs to fight international tax avoidance. The relatively recent proliferation of anti-tax haven legislation, following the earlier 1962 anti-tax haven Subpart F legislation of the U.S.A., demonstrates the primary importance which most states attach to unilateral measures. However, the increasing number of international initiatives and the amount of international collaboration may suggest that bilateral or multilateral measures will assume a greater significance in future.

Unilateral Measures

Where unilateral measures are used to combat international tax avoidance the legislation utilised could often be exactly the same as that used to oppose purely domestic tax avoidance. The Carter Commission in Canada[83] identified four possible approaches to combatting avoidance; the sniper approach (specific provisions to deal with specific activities or situations); the "shotgun" approach (a general provision aimed at a wide range of activities deemed to be unacceptable); the "arm's length" approach (under which the fisc is entitled to substitute prices in transactions between associated enterprises); and the "administrative control" approach (under which wide powers are given to an official or administrative tribunal in order to counteract tax avoidance activities).

Although this categorisation is widely used, it is not comprehensive. Most significantly, it does not include the "substance over form" approach (known in a

number of jurisdictions as "abus de droit").[84] This is probably due to the fact that this doctrine is hardly recognised in Canada.[85] It is however very important elsewhere, and has, for example, long been part of the U.S. tax authorities armoury, following the 1934 case of Helvering v. Gregory.[86] The doctrine has recently been subject to judicial development in the U.K. courts, notably in the cases of W.T. Ramsay Limited v. IRC,[87] IRC v. Burmah Oil Co. Limited[88] and Furniss v. Dawson.[89] The "substance over form" doctrine is similar in effect to the "shotgun" approach mentioned above, although it is often applied in the form of common law rather than as statute.

The Carter Commission statement of methods to combat tax avoidance activities also omits such approaches as "retrospection" (the enactment of specific provisions which operate retrospectively) and "rationalisation" (the elimination of tax anomalies in the tax system which themselves provide the opportunity for avoidance).

International Measures

The principal element common to bilateral or multilateral measures against international tax avoidance is the increased exchange of information between fiscal authorities.

There are three principal methods of exchanging information which are set out in the O.E.C.D. Model Convention as follows:

(a) On request, with a special case in mind.

(b) Automatically, as where, for example, there is an agreement to transmit systematically certain types of information.

(c) Spontaneously, for example in the case where a state has acquired through certain investigations information which it supposes will be of interest to another state.[90]

There is no doubt that all these methods are used in practice nor that the amount of information so exchanged has considerably increased in recent years.[91] As well as this increased exchange of information, there is also a general trend towards mutual assistance in tax matters.

This is illustrated by the publications of the United Nations document "International Co-Operation in Tax Matters" which is one of the most significant events in the field of international co-operation against evasion and avoidance of tax in recent years. Taken with Article 26 of the U.N. Model Double Tax Convention (dealing with exchange of information) to which it refers, the document gives the most comprehensive treatment of mutual co-operation and exchange of information between tax authorities. The document is the first truly international code to deal in detail with a variety of aspects of co-operation and exchange of information, including assistance in assessment and collection, visiting tax officials, information relating to tax haven activities, bank secrecy and the categories of information to be exchanged.

Other developments have also taken place over the last two decades or so. While the larger international institutions, such as the United Nations and the O.E.C.D., have played a significant role in increasing the international exchange of information, the smaller regional groupings have made progress in implementing a concerted attack on international tax avoidance. The multilateral Nordic Convention is a case in point. This binding international agreement concentrates on practical rather than theoretical issues and contains such innovations as providing for one state to assist in the collection of a tax owed to the other state.[92]

The Member States of the E.E.C. are, similarly, moving to adopting a common approach to international tax avoidance. The Communication from the Commission to the Council and to the European Parliament, "Community Action to Combat International Tax Evasion and Avoidance" is perhaps the clearest statement of current E.E.C. thinking on the matter. The Communication clearly recognises the need for a community approach:

> "International tax evasion and avoidance unquestionably have implications for the community and increasingly demand a community approach..."[93]

The action to be taken by the community is expressed to be:

(a) Increased collaboration between tax administrators within the community and establishing or improving co-operation with non-community countries. (For example, in 1980 the Commission asked the Council for authorisation to open negotiations with Finland, Iceland, Norway and Sweden with a view to their participation in the exchange of information provided for in Community Directives).[94]

(b) To prevent the abuse of tax shelters.

(c) To combat abusive transfer pricing practices carried on between companies belonging to the same group.

(d) The elimination of double taxation.

The Commission is critical of the way Member States have operated their mutual assistance on a bilateral basis and is keen to establish a fully multilateral exchange of information procedure:

> "The member states still seem to be operating mutual assistance on a purely bilateral basis, as envisaged under traditional bilateral conventions, showing little awareness of the possibilities for a

> multinational exchange of information which it was the very purpose of the Community Directives to establish and develop.";[95]

The Commission has emphasised for some time the close link that exists between measures against tax avoidance and the prevention of international double taxation.[96] Aware that international double taxation can arise in situations where fiscal authorities of two or more states are unable to agree in, for example, a transfer pricing dispute, the Commission has proposed a Directive aimed at establishing a procedure that would guarantee the elimination of double taxation in all cases.[97]

However, although the Communication provides evidence of the significant progress that can be achieved by regional groupings in taking a common stand against international tax avoidance, the communication also demonstrates the typical problems involved in such an exercise and these are a significant constraint on the ability of states to act wholly in concert on this issue.

The Communication document mentions two different sorts of constraint. On the one hand there is the inevitable difficulty in reconciling states to a single view when the positions of individual states may be widely disparate. In discussing the measures necessary to deal with letter box companies, the document states that:

> "The Commission looked at a number of such measures already operative in some member states under which certain tax effects were applied to payments made to a tax haven from a Member State (e.g. charging a withholding tax on royalties, shifting the burden of proof, etc). A more thorough examination revealed that the generalised application of such measures on the basis of common rules would hardly be feasible".[98]

The document also points out that even if agreement could be reached, but the measures were implemented with varying success from one national administration

to another, "this might engender fresh distortions of competition, making matters worse, not better".[99]

The other constraint arises even where agreement can be reached between all Member States and where the measures are implemented with uniformity. The difficulty is that the application of strong anti-avoidance measures may detract from the Community's competitive position unless similar provisions were applied in a wider sphere:

> "As regards the introduction of measures to resolve the problems of substance, whether the use of tax shelters or transfer pricing, considerable caution is called for if the Community's position is not to be weakened or legitimate interests injured. It would also be wise to wait until unequivocal lessons can be drawn from the application of the O.E.C.D. directives".[100]

The O.E.C.D. has perhaps proved the most influential body in developing a multilateral approach to a number of issues. The Committee of Fiscal Affairs of the O.E.C.D. has recently published reports on tax havens, abuse of bank secrecy, treaty shopping, the use of base companies and thin capitalization.[101] The intention behind these reports is to develop a common approach to a number of perceived problems relating to the taxation of international transactions and arrangements.

CHAPTER 2 - NOTES

1 OJ No C 35 of 14 February 1975, page 1.

2 OJ No L 336 of 27 December 1977, page 15.

3 Council of Europe, Colloquy on International Tax Avoidance and Evasion, I.B.F.D., (Amsterdam, 1981).

4 "Tax Avoidance/Tax Evasion" was the subject of attention of the International Bar Association at its 1980 and 1981 Annual Congresses.

5 International Fiscal Association, Tax Avoidance/Tax Evasion, Cahier de Droit Fiscal International, Vol. 68a, (Kluwer, 1983).

6 Council of Europe; International Tax Avoidance and Evasion (Amsterdam, 1981), page 181.

7 The recent tendency of a number of governments of developed countries to reduce the role of government should logically lead to a reduction in tax burdens and a possible reduction in tax mitigation behaviour. However, it is still too early to comment on the prospects of such a development.

8 Note 6 above, Ibid.

9 Note 6, Ibid.

10 J. Bischel, P. Gann, S. Klein, U.S.A. National Reporters, International Fiscal Association Cahier de Droit Fiscal International, 68a (Kluwer, 1983) page 333.

11 U.N. Ad Hoc Group of Experts, Third Report, "Tax Treaties between Developed and Developing Countries" (New York, 1972) Annex 111, page 120.

12 In the U.K. for example, "the courts have not always been too careful in drawing the distinction, sometimes saying "evasion" when "avoidance" is intended", A.J. Easson, Cases & Materials in Revenue Law, (Sweet and Maxwell, 1973) page 26. A number of illustrative cases are cited by Easson, to which may be added the remarkable recent example given by Lord Scarman who has talked of "the limit beyond which the safe channel of acceptable tax avoidance shelves into the dangerous shallows of unacceptable tax evasion" and, further; "what has been established with certainty by the House in Ramsay's case is that the determination of what does and what does not, constitute unacceptable tax evasion is a subject suited to development by judicial process" (Furniss v Dawson, 1984 STC, 156).

13 As used, for example, by the Institute of Economic Affairs in their publication "Tax Avoision", IEA Readings 22 (IEA 1979).

14 O.E.C.D. Committee on Fiscal Affairs, "Tax Evasion and Avoidance" (Paris, 1980) page 6.

15 Professor Arthur Shenfield, "The Political Economy of Tax Avoidance", IEA Occasional paper 24 (IEA, 1968).

16 Professor G.S. Wheatcroft "The Attitude of the Legislature and the Courts to Tax Avoidance", Modern Law Review, May 1955.

17 Note 16, Ibid.

18 Note 14, Ibid, page 7.

19 Note 14, Ibid, page 5.

20 This point was confirmed as early as 1925 - see the League of Nations, Technical Experts' Report, Double Taxation and Tax Evasion (Geneva February 7th 1925) Document F.212 and especially part III Section I on the definition of tax evasion.

21 O.E.C.D. Committee on Fiscal Affairs, Tax Evasion and Avoidance: (Paris, 1980), page 5.

22 The present law developed from Millar v Taylor (1769) 4 Burr 2303, cited by Craies Statute Law (7th ed.) page 128, Halsburys Laws of England (4th ed.) vol 44 para 901 and Rawlinson (see note 22) as the earliest authority. The position in law referred to in the Chapter has however been completely changed by the recent House of Lords decision in Pepper v Hart [1992] STC 898.

23 [1968] A.C. 58 at page 73. For a discussion of the English law on the use of Parliamentary materials, see M. Rawlinson "Tax Legislation and the Hansard Rule [1983] BTR 274.

24 C.I.R. v Hinchy, 38 TC 625.

25 Dr. B. Bracewell-Milnes, Tax Avoidance and Evasion, Panopticum Press, (London, 1979), page 32. See also John Chown: "The Case for Specific Anti-Avoidance Legislation" (Institute for Fiscal Studies conference, 28th June 1974).

26 Sir Alexander Johnston, Conference held by the Institute of Fiscal Studies, 28 June 1974, page 28.

27 J. Tiley, Revenue Law, 3rd Edition, (Butterworths, 1981), page 595.

28 In the U.K. for example, there is ICTA 1988, s. 739 (transfer of assets abroad). The worldwide "thin capitalization" doctrine which is presently being evolved is arguably an international example.

29 For example, the celebrated dictum of Lord Clyde: "No man in this country is under the smallest obligation, moral or other, so as to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his store" (Ayrshire Pullman Motor Services and Ritchie v C.I.R., 14 TC 574).

30 R.E. McKenzie and G. Tullock: The New World of Economics: Explorations into the Human Experience (Richard D. Irwin, Homewood, Illinois, 1975) chapter 14.

31 Note 14, Ibid, page 6.

32 United Nations, Department of International Economic and Social Affairs, "International Co-operation in Tax Matters", (New York, 1984) pp 15-20.

33 Examples are Note 6, Ibid; Note 14, Ibid.

34 Note 14, Ibid, p. 77.

35 Professor H. Ishi, National Reporter Japan, International Fiscal Association, Cahier de Droit Fiscal International 68a, Tax Avoidance and Evasion, (Kluwer, 1983) page 477.

36 Note 35, Ibid, page 484.

37 As reported by Professor V. Uckmar, General Report, Tax Avoidance and Evasion, International Fiscal Association, Cahier de Droit Fiscal International 68a (Kluwer, 1983) page 23.

38 Under the Income Tax Act of Canada, s. 163 (2), as reported by J. Shafer, J. Solursh, Tax Avoidance and Evasion, International Fiscal Association, Cahier de Droit Fiscal International, 68a (Kluwer, 1983) pp 296-297.

39 D.H. Bloom, C.A. Sweeney, Tax Avoidance and Evasion, International Fiscal Association Cahier de Droit Fiscal International, 68a (Kluwer, 1983) pp 227-229.

40 See, generally, Dr. W. Meier, "Swiss Tax Treaty Anti-Abuse Rules", Tax Planning International Review, Vol. 8, No. 12, (December, 1981), p. 15. See also the section on Switzerland in O.E.C.D. Committee on Fiscal Affairs, Tax Evasion and Avoidance, (Paris, 1980) pp 80-81.

41 See Council of Europe; Legal Affairs: Charters showing signatures and Ratifications of Conventions and Agreements Concluded within the Council of Europe, 1987, Treaty 24.

42 Reported by Professor V. Uckmar, Note 37 Ibid, page 22.

43 Sections 153 and 238.

44 See paragraph 8 of Information Circular 73-10R2, Tax Evasion and Avoidance, April 24, 1978.

45 See the Financial Times World Tax Report, July 1985, pp 8-9.

46 Professor V. Uckmar, General Report, Tax Avoidance and Evasion, International Fiscal Association Cahier de Droit Fiscal International 68a (Kluwer, 1983) page 22.

47 Secretariat of the O.E.C.D.; "O.E.C.D. Work on Tax Avoidance and Evasion" in Council of Europe; International Tax Avoidance and Evasion (Amsterdam, 1981) page 13. See also O.E.C.D. Committee on Fiscal Affairs, Tax Evasion and Avoidance; (Paris, 1980) page 5 where similar observations are made.

48 It is notable that the avoidance-evasion distinction breaks down even in documents which purport to uphold it. See, for example, the United Nations document, "International Co-Operation in Tax Matters" (cited at note 31 at paragraph 203 where there is an implication that "avoidance" activity is to be regarded as a fiscal crime.

49 O.E.C.D. Committee on Fiscal Affairs, "Tax Evasion and Avoidance", (Paris, 1980).

50 Note 49, Ibid, page 6.

51 Note 49, Ibid, page 6.

52 For example, the U.K.. See further the discussion in chapter 6.

53 Note 49, Ibid, page 5.

54 Note 47, Ibid, page 7.

55 Department of International Economic and Social Affairs "International Co-Operation in Tax Matters" (New York, 1984), page 12.

56 On treaty shopping, see O.E.C.D. Committee on Fiscal Affairs, Issues in International Taxation No. 1, International Tax Avoidance and Evasion, (Paris, 1987), which contains a separate report entitled

"Double Taxation Conventions and the Use of Conduit Companies". On thin capitalization, the same body has published in Issues in International Taxation No. 2 (Paris, 1987) a separate report entitled "Thin Capitalization". "Thin Capitalization" is anti-tax avoidance doctrine to prevent payments from a subsidiary in one country to its parent in another where such payments are disguised as payments of interest.

57 Note 55, Ibid, page 11.

58 See for example in domestic legislation: ICTA 1988, s. 770 (U.K.); IRC s. 482 (U.S.); Article 57 Code General des Impots (France); Aussensteuergesetz s. 1 (Germany); etc. Transfer pricing provisions are also contained in bilateral double tax treaties, usually following Article 9 of the OECD Convention.

59 It should also be emphasised that, although an enthusiastic amateur in the field of political economics, the author is in no sense properly qualified to carry out any sophisticated appraisal of economic arguments, nor to judge them by reference to what may be referred to as the "mainstream view".

60 Note 55, Ibid, pp v, 11.

61 O.E.C.D., Committee on Fiscal Affairs, "Tax Evasion and Avoidance" (Paris, 1980) page 13.

62 New Zealand Ministry of Finance, Consultative Document on International Tax Reform, December, 1987, pp i, v.

63 For example, see further Professor D. R. Myddleton, "Tax Avoidance - Its Cost and Benefits" contained in Tax Avoision, IEA Readings No. 22 (London, 1979).

64 Tax Avoidance and Evasion: The Individual and Society, Panopticum Press, (London, 1979); The Taxation of Industry, Panopticum Press, (London, 1981); The Economics of International Tax Avoidance, Kluwer, (Amsterdam, 1980).

65 B. Bracewell Milnes, Tax Avoidance and Evasion: The Individual and Society (Panopticum Press, 1979) pp 34-35.

66 For a more recent discussion, see Ludwig von Mises; Human Action, William Hodge (Edinburgh, 1949).

67 Note 65 Ibid, page 109.

68 Note 65 Ibid, page 110.

69 Note 65 Ibid, page 85.

70 Communication from the Commission to the Council and to the European Parliament COM (84) 603 final, Brussels, 28 November 1984.

71 Note 69, Ibid.

72 B. Bracewell-Milnes, The Economics of International Tax Avoidance, (Deventer, 1980) foreword.

73 This may suggest that economic criteria could help in determining what avoidance activity is to be regarded as "unacceptable".

74 Central Bank of Ceylon, Review of the Economy 1975, page 188, as quoted in B. Bracewell-Milnes, Tax Avoidance and Evasion, (Panopticum Press, 1979) pp 38-39.

75 Note 72, Ibid.

76 Unpublished letter dated 15th February 1988 from Bruce Sutherland, Chairman of the Taxation Committee of the Institute of Taxation to the Financial Secretary, the Rt. Hon. Norman Lamont M.P.

77 Note 21, Ibid, pp 86-96.

78 Note 77, Ibid, p.86.

79 The lack of agreement should be evident from the earlier discussion relating to the concept of tax avoidance.

80 U.K. Monopolies Commission Report "A Report on the Supply of Chlordiazepoxide and Diazepam", February 13 1973.

81 The Hoffman La Roche controversy, although not the subject of litigation, was a landmark event in the U.K. in this context for tax purposes. Specifically, as a result of the issues highlighted in the Hoffman La Roche controversy the Inland Revenue created a specialist transferpricing unit to deal with transferpricing issues involving U.K. taxpayers.

82 For example, the New Zealand Consultative Document (see note 62) contains at p.i the following statement: "The Government is determined to prevent the erosion of the income tax base by cross-border transactions which enable the deferral or complete avoidance of tax properly payable in New Zealand. The use of tax havens in particular has become widespread and has been a drain on government revenue".

83 Canadian Royal Commission on Taxation (1966), Vol 3, App. A, page 522 et seq. - this is discussed in J. Tiley; Revenue Law (3rd ed, Butterworths, 1981) pp 593-596.

84 For the extent to which the "substance over form" doctrine corresponds to the continental "abus de droit" concept, see D. Ward et al; "The Business Purpose Test and Abuse of Rights" [1985] British Tax Review 68.

85 See further, Revenue Law Committee of the Law Society; "Tax Law in the Melting Pot" (London, 1985). Appendix 1 (B), pp 61-73, discusses the position in Canada and concludes (page 72) "A business purpose test is not part of the general law of Canada at the present time".

86 69F.2d 809 (2nd Cir 1934), affirmed 293 United States 465 (1935).

87 W.T. Ramsay Limited v IRC [1981] STC 174.

88 IRC v Burmah Oil Co. Limited [1982] STC 80.

89 Furniss v Dawson [1984] STC 153.

90 See Report of the O.E.C.D. Committee on Fiscal Affairs, Model Double Taxation Convention on Income and Capital (Paris, 1977), Commentary on Article 26, paragraph 9.

91 A recent paper states that the U.S. alone exchanges over 500,000 documents each year: see Arthur Andersen & Co., Revenue Exchanges of Information, (London, 1985), page 23.

92 The Nordic Convention is a tax treaty providing for extensive mutual assistance through a general exchange of information. The treaty was signed on November 9th 1973 by Denmark, Finland, Iceland, Norway and Sweden and it has been in force since 1973.

93 EC: Communication from the Commission to the Council and to the European Parliament; "Community Action to Combat International Tax Evasion and Avoidance", COM (84) 603 final, Brussels, 28 November 1984, page 1.

94 Doc. COM (80) 68 final of 20 February 1980. It is understood that the Council has not yet responded as most Member States argue that the assistance clauses included in their bilateral conventions with non--Community countries are sufficient. If this were a valid argument it would of course hold for relations between Member States too.

95 Note 93, Ibid, page 2.

96 See, for example, "General Considerations" in the proposal for a directive on the exchange of information, document COM (76) 119 final of 31 March 1976.

97 OJ No. C 301 of 21 December 1976, page 4.

98 Note 93, Ibid, page 4.

99 Note 93, Ibid, page 5.

100 Note 93, Ibid, page 5.

101 See O.E.C.D. Committee on Fiscal Affairs, Issues in International Taxation No. 1 entitled "International Tax Avoidance and Evasion" (Paris, 1987) and No. 2 entitled "Thin Capitalization" (Paris, 1987).

CHAPTER 3

TAX HAVENS

INTRODUCTION

Tax havens are often considered, erroneously, to have arisen as a product of sophisticated international tax planning in the latter half of the twentieth century. In fact, tax havens have existed for some considerable time:

> "Like taxes, tax havens have their origins buried deep in the past. They vie in age with the world's oldest profession and the pendulum of their respectability has swung through almost as wide an arc".[1]

In the Middle Ages, for example, the City of London exempted merchants of the Hanseatic League from all taxes in order to attract new commerce to the city. Later, in the fifteenth century, Flanders (formerly an extensive country in Europe now a part of Belgium and Holland) removed duties on much of its trade and imposed relatively few exchange restrictions. As a result of these measures the country became a flourishing commercial centre which attracted, in particular, English merchants who preferred to sell their wool in Flanders rather than in England where higher duties and greater restrictions were in force. Similarly, from the sixteenth to the eighteenth centuries, the Netherlands imposed low duties and thereby created thriving business centres of its major ports.[2]

Although there is therefore nothing new in the availability of tax jurisdictions which provide a fiscally advantageous environment in which to conduct business, the extent to which these facilities can be and are utilised has changed radically in the twentieth century.

Historically, the type of trading or other economic activity carried on in tax havens has generally been limited to the local market of the tax haven. However, following the technological advances in communications made in recent decades a number of activities may now be efficiently conducted from tax haven locations which are far removed from the place or places where the impact of such

activities will be felt. This is particularly true of the service sector in general and of financial services in particular. Therefore, it has in recent decades become a considerably more practicable option to use tax havens. This fact is inevitably reflected in the use currently made of tax havens:

> "What has constituted a new phenomenon in the second half of the twentieth century is the scale on which individuals and corporations have shifted their operating bases from place to place in search of such relief [complete or partial tax relief] or refuge from political interference with their assets."[3]

It is now relatively easy to set up a business in a tax haven notwithstanding that such a business is dependent upon markets or commercial activities in locations which are a considerable distance away. Furthermore, since such businesses could be sited almost anywhere, it is to be expected that the choice of location is influenced by fiscal factors. Examples of the types of business for which a tax haven is a particularly appropriate location in this sense include captive insurance companies, leasing companies, group finance companies, investment management companies, licensing companies, etc.

It is this new-found ability to situate certain activities in tax haven locations that has radically changed the use that can be made of tax havens in general. Where such activities are carried on in tax havens, corporate entities, registered and protected under the laws of the tax haven jurisdiction, are often utilised as vehicles for gaining legal autonomy and legal personality under local law. The economic activities of such companies are not geographically restricted or dependent on the jurisdiction under the laws of which they have been incorporated. Indeed, the most favourable tax treatment accorded by some tax havens often arises only on the condition (imposed usually by the fisc of the tax haven country) that a company carries on no commercial activity within the borders of its host country.[4] It is for this reason such companies have come to be

called "base" companies. The operation of base companies is described later in this chapter.

There are a number of attributes which a tax haven is required to possess for it to represent an attractive location. Tax advantages are obviously required but it is important to note that a low tax rate is not in all cases the primary requirement. A location may be regarded and used as a tax haven, notwithstanding it has a relatively high rate of tax, because, for example, it does not tax offshore income or because it has an extensive network of favourable double tax treaties. The various types of fiscal advantages offered by tax havens are surveyed later in this chapter.

In addition to tax factors, there are a number of non-tax attributes which also contribute to making a tax haven an attractive and viable location for commercial activity. Such attributes generally include some or all of the following: political and economic stability;[5] secrecy of operations;[6] professional services (i.e. banking, financial, accounting and legal services) and communications facilities. The complete lack of these basic attributes is the reason why certain would-be tax havens (e.g. Nauru) have not succeeded in attracting any volume of tax haven business.[7]

It is important that a tax haven has laws and regulations which promote, rather than detract from, its status as a tax haven. This usually means that, in the area of company law for example, the law should be conducive to the swift creation, running and winding-up of a company; should permit the use of bearer shares and nominees; and should not place restrictions on the nationality of shareholders and directors; etc.

The lack of currency and exchange control regulations is also regarded as an important aspect of the majority of tax havens.

The domestic markets of the tax haven country may be an important factor for two reasons. Most obviously, the entity created in the tax haven may set about exploiting the local markets and thereby expand the scope of its activities. Secondly, it may be desirable in some cases for a company or other entity not to be situated in a state which is obviously a tax haven. A number of companies have been set up in "respectable" tax havens such as Switzerland, the Netherlands and Hong Kong since all of these countries have strong economies which are not by any means based on their status as tax havens, in contrast to Liechtenstein, for example.

In addition to the above attributes which are generally required of a tax haven, there are a number of other characteristics which are often associated with tax havens. These are often in the nature of incentives made available to attract foreign capital.

Tax-free trade zones, free ports and similarly designated areas offer benefits such as freedom from customs tariffs, quotas and excise taxes,[8] although these and similar incentives are offered by almost all countries in one form or another.[9] In addition, several tax havens offer guarantees against unfavourable changes in tax rates or bases within a specified period of time.[10]

The governments of some tax havens have sought to enhance the attractiveness of their state by offering guarantees against the expropriation of assets or nationalisation by the state as part of their incentive or remittance laws. These guarantees provide a long-term measure of security and contribute in each case to the relative appeal of that tax haven, though they are of course dependent on the political and economic stability of the tax haven.

Before passing on to explore certain detailed issues relevant to tax havens, it is first necessary to address certain matters of nomenclature. The very use of the term 'tax havens" may seem to indicate a clear grouping of territories which may be identified as tax havens. This is not the case and the various problems arising

from the definition, or identification of tax havens are therefore dealt with later in this chapter. Certain preliminary comments may be made at this point. First, notwithstanding the definitional difficulties (and the varieties of the species) it is probably fair to say that whilst the "penumbra" of the tax haven population may be open to debate, its core is more readily identifiable. There are for example, few who would deny that the Cayman Isles represent a tax haven state.

Second, even those who are well aware of the difficulties of referring to "tax havens" as if the concept were unproblematic find themselves adopting that approach for convenience.[11] Therefore, the term "tax havens" is used both in the title of this thesis and the discussion throughout it in a non-scientific manner and subject to the more detailed discussion of the definitional problems which appears later in this chapter under the heading "The Definition of a Tax Haven".

THE USE OF TAX HAVENS

Tax havens can be used in a wide variety of ways to achieve both tax and non-tax objectives. An influential U.S. Treasury Department report entitled "Tax Havens and their use by United States Taxpayers - An Overview"[12] found that tax haven operations can be grouped into four main categories:

i) Transactions in which there is no tax motivation in the use of a tax haven.

ii) Transactions which are tax motivated but which are consistent with both the spirit and the letter of the law governing the particular operations.

iii) Transactions which are tax motivated and which are technically legal but take advantage of an unintended legal or administrative loophole.

iv) Tax evasion through the fraudulent use of tax havens.

This categorisation is a helpful starting point in defining the types of activity that involve tax havens, though the distinction between categories (ii) and (iii) does rest on the assumption that it is sensible to separate "acceptable" from "unacceptable" tax avoidance. This assumption was considered in the last chapter and, on the basis of that earlier discussion, it is perhaps preferable to modify the categorisation suggested by the U.S. Treasury Study and group tax haven operations into three main categories; non-tax-motivated operations, tax-motivated operations within the law and fraudulent or questionable operations.[13] This categorisation will be adopted below in a short discussion of tax haven activities.

Non-Tax-Motivated Operations

There are very many ways in which tax havens can be used for non-tax-motivated objectives.

Tax haven locations may be used to circumvent rules and regulations which apply in the state in which the taxpayer is resident. For example, U.S. banks may establish branches in a tax haven to avoid the reserve requirements or interest rate ceilings that would apply had the branch been established in the U.S. Similarly, foreign exchange restrictions, strict disclosure requirements, minimum wages legislation, safety legislation and other bureaucratic controls which apply in the domestic state of the taxpayer might all be avoided by the use of a tax haven entity. Where a company considered itself to be under threat of nationalisation or vulnerable to trade union actions, relocation in a tax haven may also be considered.

The use of an intermediary company located in a tax haven can be used to disguise the origin or the destination of goods in order to avoid the effects of boycott legislation. Such an intermediary company situated in a tax haven would also prove an appropriate vehicle in cases where it was not possible to do business with another country except from a base in a neutral state.

The secrecy surrounding tax haven operations may also be an important factor to a taxpayer who wished to avoid publicity or to remain anonymous. The permissible use of nominee shares and bearer instruments in a tax haven would naturally assist this objective.

Where regional rules or regulations apply, these may also be avoided by resorting to the use of a tax haven. For example, companies in E.E.C. countries may move to havens in order to avoid E.E.C. Directives on company law.

Finally, a presence in a tax haven may also be necessary where a company seeks to penetrate the domestic market of the haven or where a company seeks to exploit the resources (whether natural or human) that are available there.

The above discussion of the various uses of tax havens is clearly not exhaustive but is intended merely to provide an indication of the wide variety of non-tax uses to which a tax haven may be put. However, in acknowledging a distinction between tax and non-tax uses of a tax haven, it is important not to obscure the fact that, although non-tax-motivated uses of havens clearly do exist in abundance, these transactions often have significant tax effects and may offer a potential for tax avoidance and evasion. It is primarily for this reason that fiscal authorities take a keen interest in apparently non-tax motivated activities in tax havens and have sought to restrict the free use of certain types of tax haven operations.

Tax-Motivated Operations

From a purely tax perspective, tax havens exist as a result of the fact that not every country in the world has the need or the ability to impose the same tax burden. Prior to the 1980s, the huge rise over the last hundred or so years in the tax rates levied by certain (usually the more developed) countries has led to a widening of the differential tax rates between high-tax and low-tax states, (although this trend has to some extent been reversed over the last few years with the reduction of tax rates in a number of developed states).

There appears to be general agreement that the existence and use of so many tax havens has come about as a direct response to the high levels of taxation in virtually all modern industrialised countries. This response is, of course, to be expected:-

> "Action causes reaction; demand creates supply. The taxpayer's demand for a lower tax burden is an almost automatic reaction to the heavy weight of present taxes. The response is just a specialised type of business - the tax haven business - and is as logical and natural as any other market response".[14]

The tax-motivated uses of tax havens can be engineered by a taxpayer to achieve one or more of a wide variety of tax objectives. The following examples give some indication of the possible range of tax benefits that may be sought:-

i) A reduction of the taxpayer's overall tax burden as a result of moving business operations from a high tax jurisdiction to a tax haven.

ii) A deferral of the payment of taxes on income from foreign sources by the use of a tax haven vehicle, thereby enabling profits to be accumulated in a tax haven at a low (or no) tax cost.

iii) A circumvention of potential future taxes that might arise in a high tax zone.[15]

iv) A reduction of the average foreign tax burden in order to minimise the loss of foreign tax credits. This may be necessary either because there is only a source by source tax credit system available or because foreign taxes as an average are relatively higher than domestic taxes.[16]

There are of course a number of other ways in which tax-motivated actions can be effective: the common element is that fiscal advantages are procured.

John Chown offers an alternative explanation of the ways in which a haven can be used for fiscal ends. For Chown, the uses of a tax haven for tax reasons can be separated simply into activities of profit diversion and activities of profit extraction.[17] The categorisation of tax motivated operations involving tax havens as either profit extraction or profit diversion is not sufficiently comprehensive and fails, for example, to take account of the use of tax havens to reduce the average foreign tax burden (see (iv) above). However, the concepts of profit extraction and profit diversion are important and will be referred to later in this thesis. They therefore require clarification.

Profit diversion consists of diverting profits to a tax haven where little or no tax is payable. An example of such a manoeuvre in the field of transfer pricing illustrates the concept. For example, if the rate of tax in country A is 50% and the rate in country B is 30% and a subsidiary company (S1) in country A sells goods to a fellow subsidiary (S2) of the same multinational group in country B, the group as a whole would gain from the lowest possible invoice price. If, say, 10,000 units of raw material were sold at £90 instead of £100 each, the profits accruing to S1 in country A would be reduced by £100,000 and the profits of S2 in country B would be increased by the same amount in pre-tax terms. However, because of the difference in tax rates, there would be an after-tax saving of £20,000 (being 50-30% x £100,000).

An even greater saving is possible if the goods were invoiced through a fellow subsidiary, S3, in a third country, C, which levies no tax at all. In this case S3 would buy from S1 at a low price and sell to S2 at a high price, thus collecting or "diverting" all the profits, by means of the transfer price mechanism, to S3 in country C. Moreover, such use of transfer prices, being a form of diversion rather than extraction of funds, will not be subject to withholding taxes and will therefore render a double benefit. If required, the profits in S3 could be made available to either S1 or S2 by means of an "upstream loan", the interest payments on which are deductible for the purposes of the tax computation of S1 or S2 and tax-free in the hands of S3.[18]

Profit extraction consists in taking profits from a high tax country to a country where they will be subject to little or no tax. In many circumstances it will be necessary to arrange the payments in such a way that they qualify as an allowable deduction against the taxable profits in the country of origin, thus reducing the taxable profits there. For example, payments of interest and royalties from a high tax country to a tax haven associate will generally lead to a reduction of taxable profits in the former state and an increase in profits in the tax haven associated company.

A "base company" vehicle located in a tax haven can be used for the purposes of both profit diversion and extraction. A base company can be any sort of company, (i.e. a finance company, a holding company, a trading company etc.) which is set up in a no- or low-tax haven to collect income which would otherwise arise directly to a taxpayer and be subject to taxation in the taxpayer's state of residence. The base company is effective in sheltering the income from tax in this way because it is in law an entity with its own separate personality and recognised as such in the taxpayer's state of residence. As a result, income accruing to the base company is not regarded as income of the taxpayer and is therefore not subject to tax in the hands of the taxpayer. This sheltering from tax will exist only so long as the income of the company is not distributed and is therefore arguably a means of tax deferral rather than a complete avoidance of tax.

A base company can be used for the purposes of profit diversion by arrangements which route income to it away from associated companies in high-tax jurisdictions. Profit extraction using a base company would entail remittances of profits from a company in a high-tax state, such payments being disguised as royalties or interest, for instance.

The existence (and use) of base companies is a matter of concern to most tax authorities and a number of measures have been enacted by them to prevent the tax-motivated use of such companies.[19]

Fraudulent or Questionable Operations

The use of tax havens for fraudulent or questionable operations may or may not involve tax factors. Non-tax motivated but fraudulent uses of tax havens include such activities as money laundering and commercial fraud operations.[20] Tax-motivated uses would include all activities involving the evasion of taxes. Whilst certain activities clearly can be recognised as international tax evasion, there is, as has been noted, no absolutely clear border between international tax avoidance and international tax evasion. This difficulty has already been discussed in the last chapter and it will suffice to observe here that fiscal authorities frequently assume the same suspicious attitude to activities in tax havens, irrespective of whether they are apparently non-tax-motivated or tax-motivated and whether they are perfectly within the law or "unacceptable" avoidance as judged by the fisc.

Although the above categorisation of tax haven usage should assist in the analysis of tax haven activities, it must be remembered that in practice it will rarely be possible to attribute a single, clear motive exclusively to explain the use of a tax haven. There is in practice usually a range of political, financial, commercial and tax considerations underlying the decision to use the facilities of a tax haven. It is probably for this reason that tax authorities are usually interested in the tax haven activities conducted by persons within their jurisdiction, notwithstanding that such activities may seem, prima facie, to have no tax implications or motivation.

ATTITUDE OF DEVELOPED STATES TO TAX HAVENS

The general perception of, and attitude to, tax havens by developed states is reflected in the introductory remarks to the recent New Zealand Consultative Document on international tax reform:

> "The Government is determined to prevent the erosion of the income tax base by cross-border transactions which enable the deferral or complete avoidance of tax properly payable in New

Zealand. The use of tax havens in particular has become widespread and has been a drain on government revenue".[21]

The use of tax havens is therefore generally regarded as a major factor in the facilitation of international tax avoidance. It is therefore no surprise that the fiscs of the developed states generally adopt a hostile attitude to the use of locations which they perceive as tax havens.

The most comprehensive discussion of tax havens, which provides an authoritative view of the attitude to such states by developed states, is contained in the recent report by the O.E.C.D. Committee on Fiscal Affairs, "Tax Havens: Measures to Prevent Abuse by Taxpayers".[22] In view of the broad composition of the O.E.C.D.[23] and the influence of the work in the fiscal domain carried out by its Committee on Fiscal Affairs, the report is undoubtedly an important document in the development of an international approach to tax havens by fiscal authorities. The concerns of those authorities are stated in the first paragraph of the paper:

> "International tax avoidance and evasion through the use of tax havens is one of the most important and long-standing concerns of the tax administrations of most O.E.C.D. Member countries. The use of tax havens by various types of taxpayers (individuals and firms) has been increasing over the past decades to the detriment of both tax revenues and tax morale. Insofar as investment decisions are influenced by tax motives, the use of tax havens leads to decisions at variance with what a neutral tax system would command, and results in undesirable economic distortions, particularly capital flows. Also, competition is being distorted between those taxpayers who make use of taxpayers and those who do not".[24]

The above statement identifies the three concerns held by developed states in connection with tax havens: they lead to a depletion of tax revenues in developed states; they have a non-neutral effect economically, particularly in capital flows; and they lead to a distortion in competition. Of these three concerns, the first (the loss of taxable revenue) is undoubtedly the most significant to the tax authorities and this explains why the majority of the O.E.C.D. report is given over to a review of the measures available to combat the unacceptable use of tax havens with a view to preventing the tax leakage caused by the use of havens in general. This point, relating to the perceived loss of tax revenues, is discussed below. The other two points, relating to competition and non-neutrality are discussed later in this chapter.

After discussing the characteristics of tax havens, the report goes on to examine "the size of the tax haven problem", stating that the "report is concerned with losses of revenue to tax authorities caused by the use of tax haven facilities".[25] The report notes that it is extremely difficult to determine how much tax is lost by the relatively high tax countries but that available data shows that certain types of financial activities, such as direct investment and bank deposits, are found at disproportionately high levels when compared with the actual economic base of the state concerned. The report draws on information provided in both the Gordon Report[26] and a further report which relates to Caribbean tax havens, "Tax Havens in the Caribbean Basin".[27] The overall conclusion of both reports is that the use of tax havens is increasing. This conclusion is accepted by the O.E.C.D. report and, by implication, interpreted as meaning that the "tax haven problem" is escalating,[28] although no specific evidence is adduced by the O.E.C.D. report itself.

In broadly assuming a "tax haven problem", the report is representative of an attitude which is clearly adopted by the fiscs of most developed states. This attitude, insofar as it has been expressed by the fiscs of the U.S. and U.K., will be discussed in later chapters in this thesis.

The O.E.C.D. report is also representative of another feature which is constantly evident in official papers and discussions on tax havens and international tax avoidance generally, namely the paucity of evidence adduced to support official claims about the effect of tax havens or of "the size of the tax haven problem". This feature will also be reconsidered in the later chapters dealing with the U.S. and U.K. position.[29]

There are of course difficulties in establishing the economic effects of tax havens on developed states and in quantifying the amount of taxable revenue that may be concerned. However, such difficulties are broadly those facing all forms of economic research and should not prove insurmountable. The chief problem, it is submitted, is that the fiscal authorities have broadly assumed there is a sizeable problem from the mere existence and use of tax havens and are therefore more anxious to consider ways of containing this perceived problem than to devote resources to establish whether and to what extent such a problem actually exists. It is to these counteracting measures that attention is now turned.

ANTI-TAX HAVEN MEASURES

The fact that it is now possible to set up a base company, for example, in a tax haven, often with minimal expense, has led to frequent challenges by the fiscs of higher tax jurisdictions as to the legitimacy of such companies and the use of tax havens in general. The various anti-tax haven measures of the U.S.A. and the U.K. will be considered in detail later on. For present purposes, it will suffice to outline the general types of measures used by states to combat the use of tax havens by companies.

Where a tax haven company is effectively managed by another company located in a non-tax haven, the tax authorities of the controlling company's state may claim, for this reason, that the two companies cannot be considered as separate entities. Consequently, the income of the tax haven company would be attributed to the controlling company for tax purposes by the fisc in the state of the

controlling state, thus negating the advantages arising from the use of a tax haven.

A number of countries have legislation which prohibits the transfer of assets or of business overseas. Such legislation is frequently supported by very heavy penalties in the event of non-compliance. In the U.K., for example, failure to obtain Treasury consent to the transfer from the U.K. of a trade or business resulted until 15th March 1988 in a criminal conviction and imprisonment for a term up to two years or to a fine not exceeding £10,000 or to both.[30] Exchange control legislation, whilst not being tax legislation, may also be used to similar effect.[31]

There exist various legal doctrines relating to legal form which have been used to counteract tax haven activities which lack substance. A "letter-box" company is an example of the type of tax haven company that could be attacked under these concepts because such companies are merely formal legal constructs and lack commercial substance. In the U.S. and U.K. the "substance over form" doctrine (considered briefly in the last chapter) could be used by the fiscs to attack these companies.[32] In Europe; the similar concept "abuse of legal form" (abus de droit) is available to the fiscal authorities. Many countries may also ignore "sham" transactions effected merely for tax avoidance purposes. There are also general anti-avoidance provisions which may be relevant. In New Zealand, for example, there is the aptly named "annihilation provision" under which any agreement shall be absolutely void insofar as "it has or purports to have the purpose or effect in any way, directly or indirectly", of avoiding tax.[33] The broad effect of all these doctrines would be to attribute the income of the tax haven company elsewhere, bringing it into the charge to tax of the state applying the anti-avoidance doctrine.

Virtually all states have requirements that transactions carried out by taxpayers in that state are entered into on arm's length terms, or, where this is not the case (for example, in dealings with an associated company), that a full market value be used as the price in such transactions. Transfer pricing legislation is the most obvious example of the measures available to the fisc in this context.

The imposition of withholding tax on payments to non-residents of interest, dividends, royalties, rents, management fees, etc is also a measure which acts as a disincentive to the use of tax havens. The withholding tax is usually reduced or removed by double tax treaty but such treaties will not generally be concluded with such an effect between high tax and low tax states or, at least, not without some undertaking of administrative assistance and exchange of information between the two signatory states. A further measure which may be directed against tax havens, though not one which has been adopted widely, is to shift the burden of proof from the tax authorities to the taxpayer in certain instances. Measures for this purpose were introduced in France in 1974. The measures provide that certain types of payment made to non-residents in a state giving "preferential tax treatment" are not deductible for tax purposes "unless the payer furnishes proof that the expenses correspond to genuine transactions and are not abnormal or excessive". If the expenses are not justified by the taxpayer, they are added back to the taxpayer's taxable income.[34]

As a result of the increased use of tax havens for the location of investment companies (mutual trusts, unit trusts, etc) a number of states, including the U.S., U.K., Canada, Germany, and the Netherlands, have legislation which either taxes investors annually on the amount of income of the investment fund relating to the year in question (as in the Netherlands, Canada and Germany) or which taxes as income any gain made by the investor on a disposal of an interest in the fund (as in the U.S. and the U.K.).[35]

Whereas the foregoing measures have been developed unilaterally, there is an increasing move to combat the use of tax havens by the use of exchange of information between fiscal authorities. Indeed, the broad conclusion of the O.E.C.D. report discussed earlier in this chapter is that increased co-operation in the exchange of information is necessary to counter tax haven activities.[36] The methods of exchanging information have already been discussed in chapter two.

Finally, there exists the type of unilateral measure which is the particular concern of this thesis. The U.S., Canada, Germany, France, Japan, and the U.K. have laws regarding the apportionment of undistributed income accumulated by a tax haven company. These laws attribute to shareholders resident within these states the undistributed income of certain tax haven companies owned by them. There are broadly three basic features to this type of legislation. First, the tax haven company must be controlled by residents of the state where the legislation is applied. Second, the company must be subject to a low level of tax in relation to the tax burden it would have been subject to had it been situated in the state applying the legislation. Third, if the above two preconditions are met, income of the tax haven company is attributed to its controlling shareholders by one of two approaches. In the U.S., Canada and Germany the income so attributed is only the "tainted" passive income. In the U.K., Japan and France all the income of the tax haven company is attributed to its controlling shareholders unless certain exemptions apply. Notwithstanding the two basic differences in approach, the legislation of all six states has a substantially similar effect.

In contrast to the various measures considered earlier the provisions aimed at the undistributed income of certain tax haven companies are designed specifically to counter the use of tax havens whereas the earlier measures are of a general character and are used in combatting a variety of tax avoidance arrangements, and not necessarily those involving the use of tax havens.

There are broadly two different approaches in the anti-tax haven legislation of these six countries.[37] Canada and the United States adopt what may be called a "transactional" or "functional" approach. This focuses on the nature of income received by a controlled foreign corporation; if this income is "tainted" then the income will be attributed pro rata to U.S. or Canadian shareholders. Since both countries provide relief for foreign taxes suffered, any tax paid by controlled foreign corporations will be offset against U.S. or Canadian tax on the tainted income. Where such foreign tax exceeds or is equal to the U.S. or Canadian tax rates, no tax will be payable in the U.S. or Canada under the anti-tax haven

legislation. In effect therefore, it is only controlled foreign corporations in low or no tax states receiving tainted income which are subject to the legislation. However, as a result of the "functional" approach taken by these countries, the U.S. and Canada have effectively enacted legislation dealing with operations in certain tax havens without having to define what a tax haven is.

This is not the approach adopted by the other four countries. There the scheme of the legislation is to concentrate not on the type of income but on the location of - or (and which often comes to the same result) level of tax suffered by - the controlled foreign corporation. Where a controlled foreign corporation is established in certain low-tax havens the legislation of these countries will apply. Since the legislation focuses on the location of the company rather than on the type of income it receives, the problem of defining a tax haven requires to be tackled. Therefore, the legislation of these four countries gives a definition of tax havens and supplements this by certain lists.

In three of these four countries (Japan, France and the U.K.) a low-tax state (effectively, a tax haven) is defined by means of comparing the foreign tax levied on the relevant company with the domestic tax that would be payable if the company were subject to the domestic tax jurisdiction. In the fourth country (Germany) this method of comparison is not used. The German legislation is something of a hybrid of the "transactional" approach of the U.S. and Canada and the "designated jurisdiction" approach of Japan, France and the U.K. German shareholders of a CFC are taxable on its tainted income where such income is subject to low taxation in the foreign country. Broadly, "low taxation" is a total tax burden of less than 30%.

PROBLEMS ASSOCIATED WITH TAX HAVENS

So far in this chapter the word "tax haven" has been used as if the concept were clear and unproblematic. This is not the case. There are a number of problems with the concept which have a significant impact on the conventional

understanding of tax havens. The following sections of this chapter explore the key areas of difficulty, starting with the primary problem, the definition of a "tax haven". This is obviously a major issue because whilst a number of states are opposed to the use of "tax havens", it is not clear that there is any generally accepted understanding of what a tax haven is.

Following the discussion of the definitional problem, the impact of the existence of tax havens on tax neutrality and commercial capacity to compete is considered, before a consideration of the fiscal sovereignty of tax havens. Finally, there is a discussion of the place of tax havens in the development of IFL.

THE DEFINITION OF A TAX HAVEN

Attempts to Define the Concept

The expression "tax haven" is commonly used in a very wide sense. However, it is an entirely separate concept from that of "tax shelter", which is capable of rather more precise explanation:

> "Broadly speaking, any investment that receives some tax favoured treatment, such as long-term capital gains or the tax exemption accorded interest on state and local obligations could be called a "tax shelter". In practice, however, that term tends to be applied mainly to some specialised investments such as oil and gas drilling ventures, real estate syndications and equipment leasing arrangements".[38]

A number of attempts have been made to offer a satisfactory definition of the concept of a tax haven. Commencing with the most literal definition, J. Van Hoorn suggests:

> "The word "haven" means harbour and thus, figuratively, refuge or place of safe retirement. "Tax haven" would then indicate a place to which one goes, or which one uses, in order to avoid taxes."[39]

Definitions are frequently based on the low or no-tax status of havens:

> "Tax havens are countries which levy very low or no taxes at all, at least on certain categories of income and profit."[40]

The difficulty with definitions which focus on the low-tax aspect of tax havens is that no account is taken of certain important tax havens where, although domestic tax rates are fairly high, transactions may in certain cases be arranged so as to significantly reduce the burden of tax that might otherwise apply (for example, The Netherlands is a prime example of a high-tax tax haven).

The broad notion of tax havens is defined more realistically by Chown and Edwardes-Ker:

> "A tax haven is a territory where assets can be held and profits can be earned without any local tax consequences or at a cost of a tax liability materially less than that ruling in the major industrialised countries."[41]

The reason it is so difficult to produce a wholly satisfactory and comprehensive definition of tax havens is due to the diverse <u>types</u> of tax haven: some are industrialised countries, some are developing countries, and some, although not independent nations in their own right, have the authority to establish their own tax regime. It is easier, therefore, to identify the various <u>categories</u> of tax haven. To offer a single definition which encapsulates the salient attributes of each category is considerably more problematic. The United Nations has observed that:

> "Despite the widespread use of the term "tax haven", no internationally accepted definition of it has yet been formulated."[42]

However, it is precisely because the term is used to refer to so many different forms of tax advantages offered by states that a unifying description is not achievable. This explains why it is possible to produce only a very generalised definition, such as those considered above, or the following, which could apply to almost every state in the world:

> "Any country which by features in its tax law (or the absence thereof) attracts the attention of tax planners."[43]

Almost any state can be considered a tax haven (in this sense) in comparison with another country. Even countries levying very high rates of taxes in general might be regarded as tax havens with respect to other countries where lower tax rates apply in respect of specific transactions or situations. Whilst this is no doubt true, the resulting notion of a "tax haven" would be so all-embracing as to be virtually meaningless. For this reason, it is easier, and certainly more useful, to identify the categories of tax haven than to offer a single all-embracing definition of the concept "tax haven".

The Categories of Tax Haven

The Rotterdam Institute for Fiscal Studies enumerate three categories of tax havens.[44] The first category contains those havens levying no or very low taxes. The second category is divided into two sub-sections: (i) states with some direct taxation on local and/or foreign items of income or capital but nevertheless special tax advantages for foreign operations; and (ii) states offering exemptions from tax only on foreign income. The third category comprises those states with normal taxation but certain special tax advantages. The Rotterdam Institute for Fiscal Studies also acknowledges there is a residual class of states offering investment incentives such as accelerated depreciation, investment allowances, etc. However,

on the ground that this class would contain more or less every country not falling within the three previous categories, this class is not considered as a separate substantive category. Saunders[45] has a similar categorisation but differs in taking rather more account of this latter residual class of states, which he merges with what is the third category for the Rotterdam Institute for Fiscal Studies, namely those states with normal taxation but certain special tax advantages.

Spitz[46] takes a similar line though with a more restricted third category than is adopted by Saunders. Spitz also introduces terms (tax paradises, tax shelters and tax resorts) to denote his categorisation in offering the following three classes of jurisdiction:-

(i) countries where there are no relevant taxes (tax paradises)

(ii) countries where taxes are levied only on internal taxable events, but not at all, or at very low rates, on profits from foreign sources (tax shelters)

(iii) countries which grant special tax privileges to certain types of companies or operations (tax resorts)."

This categorisation is similar to that offered by both the Rotterdam Institute for Fiscal Studies and Saunders and it is also similar to the categorisation adopted by Japan for the purposes of its CFC legislation.[47] However, the terms "tax paradise", "tax shelter" and "tax resort" have not gained general currency and may not prove helpful when used in this context. In particular, the use of the term "tax shelter" to denote states where there is no or very low taxation on foreign source income may prove rather confusing in some quarters since this term already has a different established meaning (which was considered at the beginning of this chapter).

The major weakness with this accepted classification of tax havens is that no account is taken of tax havens whose importance is derived primarily from their network of double tax treaties. The existence of a treaty network may be a very significant asset of a tax haven[48] and this is particularly so in the case of countries such as the Netherlands and, to a lesser extent, Switzerland.[49] The tendency to leave this type of tax haven out of the classification of tax havens may be due to the fact that such havens are frequently used in the creation of international conduits for the remittance of royalties, interest, etc, and not for the purposes traditionally associated with tax havens, such as the accumulation of capital in a tax-free environment.

To take account of this oversight, it is considered that the appropriate categorisation of tax havens for the purposes of the present brief analysis will be as follows:-

1. Havens levying no tax.

2. Havens exempting foreign source income from taxation or offering special tax advantages for foreign operations

3. Havens whose primary attraction is their network of double taxation treaties.

4. Havens which tax both domestic and foreign source income but which nonetheless offer special tax advantages.

Each of the above categories is discussed briefly below.

1. <u>Havens levying no tax.</u>

   Tax haven states falling into this category include such locations as the Bahamas, Bermuda and the Cayman Islands. All these islands have no direct taxes (i.e. no income, corporate, capital gains, withholding, gift or

estate taxes) nor have they negotiated double tax treaties with any other country.

Taking the Cayman Islands as an example, the only taxes that do exist in Cayman are duties at the rate of 20% on merchandise imported to the Islands and stamp duties which are required on most documents. There are also various business licence fees. Since the Cayman Islands is not a party to any income tax treaties, the tax authorities of other states have no right to receive information from their counterparts in the Cayman Islands.

2. Havens exempting foreign source income from taxation or offering special tax advantages for foreign operations.

Havens in this category include jurisdictions such as Hong Kong, Barbados, Costa Rica, Gibraltar, Liberia, Liechtenstein, Luxembourg and Panama.

By way of example, direct taxes in Hong Kong are levied exclusively on Hong Kong source income and comprise property tax, salaries tax, profits tax and interest tax. There is no general income tax as such. Since Hong Kong levies tax on a source basis, the place of residence of a company does not of itself affect liability to Hong Kong tax.

3. Havens whose primary attraction is their network of double taxation treaties.

Havens in this category normally have three important attributes from a tax perspective: limited or no withholding tax on incoming cash flows; limited or no tax on the receipt of that income under domestic law; and limited or no withholding tax on outbound cash flows.

The Netherlands is the most obvious example of a haven within this category. As a tax haven, the major attraction of this state is its very wide

network of double taxation treaties. Many of these treaties contain some of the most favourable provisions negotiated by any country on behalf of its residents. This fact has been recognised by a number of other states and there has been much discussion on the use of Netherlands companies as "stepping stone" or "conduit" companies to reduce corporation taxes and withholding taxes in other countries.

Other special provisions complement the Netherlands' favourable network of tax treaties. The Dutch participation exemption, contained in Article 13 of the Dutch Corporation Tax Act, is particularly important. Under this exemption dividends and capital gains received by a Dutch company from a foreign subsidiary are exempt from Dutch tax.

For the exemption to apply, the following conditions must be met: the Dutch company must hold at least 5% of the paid up capital of the foreign subsidiary from the beginning of the fiscal year in which the dividends are paid; the shares must not be held simply as an investment (which means generally that the Dutch company must perform some function in the operations of the group as a whole); and the overseas subsidiary must be subject to a foreign income tax which is similar to the Dutch corporation tax.[50]

This last condition, that the subsidiary must be taxed on its profits, means that where the subsidiary is located in a no-tax haven, any dividends remitted will bear full Dutch corporate tax whilst remittances from subsidiaries taxed at low rates will not be taxed at all in the Netherlands. For Dutch corporate groups, this inevitably makes the location of subsidiaries in low-tax havens, such as Switzerland and Cyprus, considerably more attractive than locations in no-tax havens (Bahamas, Barbados, Cayman, etc.). It also provides one reason why a company which decides to locate in Gibraltar, for example, may choose to use a qualifying company (which bears tax at the rate of 2% or 27% depending upon

whether or not the income is remitted) rather than an exempt company (which is not subject to income tax as such but is subject to the flat-fee rate of annual tax, irrespective of the level of its profits).

Other countries with sophisticated tax treaty networks are the United Kingdom, Switzerland, Belgium and France.

4. Havens which tax both domestic and foreign source income but which nonetheless offer special tax advantages.

Countries in this category include Belgium, Canada, Ireland, Luxembourg and the United Kingdom.[51]

Taking Belgium as an example, two features of the tax legislation should be mentioned: the so-called "T-zones" and also the special provisions applying to headquarters companies.

T-zones were introduced by Royal Decree in 1982 as an incentive for high technology companies to set up in designated areas in Belgium.[52] The principal benefit accorded to such companies doing business in T-zones is an exemption from corporate tax on profits (whether retained or distributed) and an exemption from withholding tax on dividends, interest and royalties paid abroad. The exemption applies for a period of ten years. A further concession exempts the company from capital duty on incorporation if it is set up for qualifying operations.

With regard to the provision for headquarters companies, the original law of 1982[53] was modified by a 1984 decree[54] following E.E.C. pressure. However, the new rules still result in very low taxes for new headquarters or officially recognised financial centres. Originally the law gave such companies a 10-year tax holiday. The new rules state that taxable income is determined by a mark-up (normally approximately 8%) on operating

expenses. However, all staff and financial expenses (usually a major portion of operating costs) are excluded from the mark-up base. The new rules are not restricted to the 10-year limit but apply indefinitely.

To qualify, the work of the company must be limited to an auxiliary or planning role for the benefit of the corporate group of which it is a member and the group must have a consolidated net worth of at least B.Fr. 1 billion and annual turnover of at least B.Fr. 10 billion. There are in addition provisions whereby the companies' foreign executives are eligible for reduced income taxes and do not need to obtain work permits and other forms of professional registration which are usually required.

Having briefly surveyed the various types of tax haven it is now possible to conclude that attempts to find a single definition to cover all types of tax havens is unlikely to prove successful because of the very diverse uses that can be made of such states.

It is also possible to draw some further conclusions on the policies of those states which are opposed to the use of tax havens for fiscal reasons. It is clear that such states are concentrating their attack on havens in categories 1 and 2 (i.e. no tax havens and havens exempting foreign source income or offering special tax advantages for foreign operations). However, even with the targeted attribute of no-tax or low-tax regimes, there are still some significant differences in precisely what countries fall to be regarded as tax haven states by the developed states. This point is taken up in Part C of this thesis in the discussion of the U.K.'s approach to tax havens in the context of the U.K. controlled foreign company rules.

The developed states are generally opposed to the use of states for "treaty shopping" purposes (category 3) but this does not appear to be perceived by them as part of the tax haven issue. Developed states do not appear to wish to oppose the use of havens falling within category 4 (special tax advantages).

TAX HAVENS AND NEUTRALITY

It was noted earlier that three reasons are given in the O.E.C.D. document on tax havens as the basis for the tax authorities' opposition to the use of such locations. The first, relating to the adverse effect on revenues collected, has already been considered. The second reason given is the prejudicial effect of tax haven usage on tax neutrality:

> "Insofar as investment decisions are influenced by tax motives, the use of tax havens leads to decisions at variance with what a neutral system would command, and results in undesirable economic distortions, particularly capital flows"[55]

It is not clear what this objection is directed at and no further details are given in the O.E.C.D. paper in which it appears. If the statement refers to a disruption of neutrality on an international level, it appears to be a totally misconceived objection. This is because the differing rates of tax applying from one state to another will in any event completely rule out any possibility of a "neutral" environment for commercial decisions from a tax perspective. (There would in addition be the concern that the tax authorities were adopting a position which does not recognise the fiscal sovereignty of the tax haven states, but this point is considered later in this chapter).

If, on the other hand, the statement refers to a disruption to the neutrality that would otherwise apply on a domestic basis, the opposition appears equally misconceived. It would always be open to a domestic participant in a commercial transaction to structure the transaction using a vehicle from any country (whether or not a "tax haven") outside the state, thus denying the possibility of tax neutrality in any event. In other words, the use of companies located in tax havens is in itself merely one aspect of the disruption to the neutrality principle (viewed on a purely domestic basis) that arises more generally whenever an overseas company is involved in the transaction. Moreover, the existence of tax incentives and reliefs

promulgated in the domestic legislation of virtually all states (e.g. The Business Expansion Scheme incentives in the U.K.[56]) is hardly reconcilable with the goal of tax neutrality. For these reasons, the objection to tax havens on the grounds of tax neutrality appears somewhat strained.

Furthermore, objections based on neutrality (such as the one cited above) are in reality often based as much on objections to tax avoidance or on the effect on competition as on neutrality. In economic terms (and as has been explained in Chapter 1) the concept of "pure" neutrality that such objections are based on is a chimera.

TAX HAVENS AND COMPETITION

The third and final reason given earlier for the tax authorities opposition to the use of tax havens is the adverse effect on commercial competition:

> "... competition between taxpayers is seriously distorted by the fact that some taxpayers can use tax havens to avoid or reduce their liability, while others do not or cannot."[57]

This is, in principle, a similar objection to that based on tax neutrality and it appears to be no more well-grounded. As before, the existence or non-existence of tax havens will not affect the existence of "distortions" to commercial competition arising as a result of the varying rates of tax applicable from one country to the next and the various incentive schemes, particularly in relation to the export of goods and services, that exist in many states, most of which are not tax havens.

Further, the "competition" (and also "neutrality") issue is an argument which can be mounted in opposition to anti-tax haven measures as well as in support of them. This is reflected in the representations made by the Business and Industry Advisory Committee (BIAC) to the O.E.C.D. (this committee is generally

responsible for representing the views of the private sector to the O.E.C.D.). In commenting on the anti-tax haven measures adopted by fiscs, BIAC commented:

> "... faced with restrictive legislation, companies will either discontinue existing operations or, more likely, change the method of conducting the operations so as to minimise the effect of the legislation, the latter course often involving higher (non-tax) costs. Since not all competitors will be equally affected by the legislation, it may have unfortunate competitive effects."[58]

There is little response to this counter argument in the O.E.C.D. paper beyond the following:

> "The use of tax havens itself distorts competition and the Committee hoped such arguments would not be used to justify attempts to avoid the impact of countering legislation."[59]

The above response hardly answers the objection raised by BIAC. In addition, it is not self-evident (contrary to the implicit assumption in the above quotation) that the use of tax havens necessarily distorts competition. There is an argument that, in some cases, the use of tax havens fulfils an important role in facilitating competition. This would be achieved by permitting companies resident in high tax states to compete more effectively with their counterparts in lower-tax states. By using tax havens in their international operations, companies otherwise facing a more punitive rate of tax may be able to compete with companies from lower tax countries on a more equal footing.

There is support for this argument in some further comments made in the O.E.C.D. paper by BIAC:

> "Much of the use of tax havens is not motivated by a desire to pay little or no tax, so much as an economic necessity to reduce costs,

> including taxes, to a bearable level in circumstances where the laws of countries are uncoordinated, and even the laws of individual countries are inconsistent insofar as they relate to the treatment of international business".[60]

In the absence of sufficient empirical evidence on the matter, no conclusions can be drawn. However, the point is relevant in demonstrating the scant regard which is paid by official bodies to arguments which tend to substantiate the necessary or desirable use of tax havens.

Thus, the argument is not by any means concluded and it still remains for the tax authorities, as those responsible for anti-tax haven measures, to make a case for such measures on the grounds of commercial competition (and neutrality).

One further point on competition should also be considered. It may be objected that if a country with a high tax rate imposes CFC legislation then that is no more anti-competitive (or, indeed, anti-neutral) in the international arena than distortions in tax rates themselves: in other words it would be as reasonable for such a state to introduce CFC legislation as it would for it to raise (or lower) its domestic rate of tax.

In one sense this entire thesis is directed at precisely this type of objection. However, the objection can be answered briefly here by drawing a distinction between business competition amongst taxpayers and competition amongst states for Revenue. As between taxpayers, tax havens are available in principle to anyone who cares to use them and are therefore an element in competition and competitive factors (just like domestic tax rates, management efficiency, access to markets, etc).

It is only when the use of tax havens breaches the accepted rules (ie. broadly the principles of IFL, as enacted in domestic legislation of states and tax treaties between states) that such use is to be objected to. States have implicitly (if not

expressly) accepted this viewpoint by subscribing to the policies and principles of IFL as reflected, for example, in double tax agreements. In short, the introduction of CFC measures will be a breach of competition between states (and will have an anti-competitive effect on domestic taxpayers affected by them) if such measures are in breach of the policies and principles of IFL. It is considered that this thesis demonstrates that this is indeed the case.

FISCAL SOVEREIGNTY OF TAX HAVENS

One further problem, to which reference has already been made, is the degree to which developed states are prepared to respect the fiscal sovereignty of states they regard as tax havens (particularly no-tax or low-tax havens). The general attitude is summed up by the United Nation"s Department of International Economic and Social Affairs, which records the international recognition (or, more accurately perhaps, reluctant acceptance) that:

> "Any country in the exercise of its sovereignty is entitled to adopt a tax system which reflects its economic preferences to charge taxes at low rates or to refrain, if it so desires, from imposing taxes at all."[61]

However, the same document goes on to state the perceived problem resulting from the exercise of sovereignty by tax havens:

> "the tax and regulatory structures adopted by any country in exercise of its sovereignty may result in tax advantages for foreigners which may have a serious impact on the tax revenue of other countries."[62]

Unfortunately, the apparent tension between the exercise of sovereignty by low-tax havens and the ability of other countries to fully recover tax revenues is not explored in the document from which the above quotations are taken (nor is it

explored in any other official document, to the knowledge of the writer) although the discussion in that document does go on to note the following:

> "A slightly different point, which ought also to be borne in mind in this analysis is that no criticism is intended by it of those countries where tax systems (or lack of tax systems) are used to provide advantages to the taxpayers of other countries. It was pointed out that those countries were free in the exercise of their sovereignty to shape their tax laws in their own way, just as it was also the sovereign right of states affected by international tax differentials to take the steps necessary to exercise the justice, equity or neutrality of their national tax systems"[63]

The statement is particularly revealing in that it reflects the real ambivalence in attitude of the fiscs of high tax states towards the fiscal sovereignty of low-tax havens. The position of most developed states seems to be that because tax havens adversely affect their tax systems (an assumption based in turn on economic assumptions for which relatively little supporting empirical data exists), unilateral (and increasingly, bi-lateral or multi-lateral) measures may be enacted to prevent the perceived detrimental effects to them resulting from the use of tax havens. In taking such a line, there is virtually no recognition of the possible effects such legislation may have on the tax system or fiscal sovereignty of the havens against which the measures are directed.[64] Therefore, notwithstanding the apparent "even-handed" attitude that appears in certain official documents, such as that referred to above, the reality on closer inspection is that the approach of most high-tax states to the fiscal sovereignty of tax havens is rather more one-sided; such sovereignty is in effect accepted only to the extent it does not have any adverse fiscal consequences for those high-tax states. Further, since many high-tax states often take the view that the mere existence of tax havens will necessarily have such adverse effects, the recognition of the fiscal sovereignty of tax havens is in practice somewhat thin.

The juxtaposition of the final two propositions in the last quotation (i.e. the freedom of tax havens to shape their own tax laws and the freedom of high tax states to act to preserve justice, equity or neutrality of their tax system) raises a number of questions without providing any answers. For example, what if the taking of steps "to ensure the justice, equity or neutrality" of a national tax system contradicts the fiscal sovereignty of a low-tax state? In what way is the fiscal sovereignty of a low tax state to be respected, if at all, by other states? Is the justice, equity or neutrality of the tax system of the low-tax haven to be respected with the same priority as applies in the case of high-tax jurisdictions and, if not, why not? These questions naturally lead on to the much larger question of the place of tax havens in the development of international fiscal law. This matter is considered in the next, and final, section of this chapter.

TAX HAVENS AND THE DEVELOPMENT OF IFL

It is the tax authorities of the relatively high-tax states which express most concern over operations involving tax havens. Not surprisingly, these tax authorities usually develop a concept of tax havens which is based on the no-tax or low-tax status of such countries and wholly disregard the fact that, in many instances, high-tax states can also be effectively used as tax havens.

In addition, the perspective of high-tax states with regard to low tax states is somewhat indiscriminate. There is practically no account taken of the varying uses made of tax havens in cases where tax avoidance is not the motivation. Instead, all such uses are generally objected to by high-tax states in their opposition to the use of tax havens by their residents. Given the blanket opposition to international tax avoidance by most developed states, this is an understandable (if not entirely justifiable) position. However, the tax authorities of high-tax states also seem at times to regard the use of tax havens for the purposes of tax avoidance as being synonymous with usage for tax evasion purposes.[65] For example, in the United Nations document 'International Co-Operation in Tax Matters"[66] there is an implication that avoidance activity is to

be regarded as a fiscal crime.[67] Similarly - and which comes to the same thing - tax authorities may not properly distinguish between avoidance and evasion:-

> "Tax administrations are concerned about both tax evasion and tax avoidance, since the tax losses resulting from them may impinge very forcibly upon the effectiveness of their operations and the equity of their tax systems. In the context of non-compliance with the tax laws, it may be considered irrelevant whether a specific activity on the part of a taxpayer is classified precisely as evasion or avoidance".[68]

The result of the above attitude taken by the tax authorities of high-tax states is that the tax haven question has become bluntly transformed into an "us/them" issue between the high-tax states on the one hand and the low- or no-tax states on the other. This development is unhelpful for a variety of reasons, not least because it obscures a number of key points which do require addressing if the development of IFL is not to be unduly prejudiced.

What is required in place of the generalised objections to tax havens is a more detailed analysis of the specific tax haven activities and uses which developed states are opposed to, together with the reasoning behind those objections. This would permit a more detailed review of the tax haven issue and develop a more rigorous analysis away from the current (and inadequate) perspective which simply equates use of tax havens with abuse.[69]

As well as a more detailed analysis of the grounds on which developed states object to the variety of uses of tax havens, there is also a need for the different types of tax haven to be more fully comprehended. At the moment, the attention is virtually exclusively turned to no- or low-tax havens, with little or no attention to the other types of tax haven. Indeed, the emphasis of the official scrutiny is perhaps already inadequate given the increasing attention being paid by tax

planners to the possibilities of higher tax havens, a development already reflected in the literature on the use of tax havens.[70]

It is therefore concluded that closer analysis is necessary of both the types of tax haven and the uses made of tax havens which are opposed by developed states. If such an approach is adopted the job of applying the policies and principles of IFL to the debate will be greatly facilitated. IFL is here relevant for two reasons.

First, the policies and principles of IFL could be applied to rationalise the issues and to determine which anti-haven measures are, and which are not, justified in terms of IFL. This first point is also relevant to the second; if IFL is applied in this way, then it will inevitably mean an increase in the sphere of application of IFL, which in turn will assist the development of IFL. Both these points (the application and the development of IFL) are central to this thesis in the context of the tax haven issue and they will be developed in future chapters by reference to the analysis of the controlled foreign company legislation.

Therefore, conclusions on the relevance of IFL to anti-tax haven legislation and to the regulation of fiscal relations between developed states and states designated as tax havens cannot be drawn until the final part of the thesis, in chapters eight and nine. However, in concluding this chapter, it is appropriate to make certain further comments in support of the general relevance of IFL to the subject of tax havens.

First, in connection with the application of the policies and principles of IFL, it should be observed that, as demonstrated in Chapter One, those policies and principles are basically generally-accepted policies and principles of taxation which lead to applicable substantive enactments of IFL. As such, they provide relatively unproblematic criteria to asses the rights and wrongs of the treatment of tax havens by developed states. In this case (and reverting back to the discussion in Chapter One) the relevant criteria will be those principles which deal with the situations in which one state may tax the profits of a company from another state

(ie. the nexus that is required to exist before such taxation may be levied) as well as the criteria of residence (and, possibly, the criteria which follow from the arm's length principle).[71]

Second, in connection with the development of IFL in this sphere, there are a number of comments to be made.

It may be questioned whether the subject of tax havens - or tax havens themselves - should be involved in the development of IFL at all. However, in view of the central importance of tax havens to the subject of international tax avoidance (which latter subject has become a dominant point in the discussion of IFL in general), it is self-evident that the subject of tax havens must be considered in the development of IFL. With regard to involving tax haven states themselves, the chief benefit of enfranchising tax havens in the development of IFL is that the major problems which are perceived to arise as a result of the existence of tax havens could be tackled by a generally accepted single approach. Thus, for example, the question of the rights of both haven and non-haven states arising from their entitlement to fiscal sovereignty might more readily be resolved by a development of the applicable rules of IFL, affecting both haven and non-haven states. Similarly, the application of IFL in this sphere may determine the legitimacy of the various forms of anti-tax haven legislation which have been considered earlier in this chapter. In the absence of such criteria being applied, it is difficult to see how such legislation could otherwise be appraised and evaluated.

If tax haven states are not involved in the development of IFL or if the subject of tax havens is not approached by developed states in accordance with the principles of IFL, the development of IFL is likely to be frustrated: IFL is developed most effectively by states co-operating to achieve its ends. If a large number of states (i.e. tax havens) are excluded from this process, the sphere of application of IFL is necessarily reduced significantly. Further, if havens perceive they are being deliberately excluded and economic activity within their jurisdiction

is subject to what they consider to be unjustifiable taxation by overseas states, this may lead to aggressive counter-measures being enacted by them. Such measures might be enacted deliberately to frustrate all anti-tax haven legislation of developed states (e.g. the enactment of wide secrecy laws to disguise completely the identity of the parties involved in tax haven transactions) or alternatively to attract further business to the tax haven in question by making it known that, for example, all business, irrespective of its legitimacy, would be welcomed. These developments would obviously aggravate relations between haven states and non-haven states and would in addition be detrimental to the development of IFL.

If tax haven states are enfranchised in the development of IFL as has been suggested above, they would be entitled to its full protection. In practice, this should mean they would not be subject to anti-tax haven measures which are in breach of the agreed principles or conventions of IFL. (For example, a tax haven state in this position should be entitled to protection from an overseas fisc arbitrarily attempting to tax economic activity in the haven state). However, the benefits would not accrue solely to tax havens. Since participation in the development of IFL brings with it certain obligations, developed states would be entitled to expect the co-operation of tax havens in applying and enforcing certain accepted bases of taxation where those bases are acceptable on the criteria of IFL. In practice, this is likely to mean that low-tax havens would be required to communicate with other states in cases involving, for example, manipulation of transfer prices or artificial allocations of profits.

Although it can be expected that such increased participation in exchanges of information would raise a number of significant issues for various tax havens with strong secrecy provisions, many tax havens are already aware of the importance of preserving their reputation and standing as bona-fide business centres. This awareness has already led to various developments or initiatives, which include the provision or exchange of information (including information relevant to tax fraud and evasion) by such states to other states including the U.S.[72]

The foregoing discussion assumes that tax haven states can be (and are willing to be) involved in the development of IFL. Partly due to the nascent state of development of IFL and partly due to the current attitude to tax havens by certain developed states, the mechanics and practicalities of such an involvement will inevitably be problematic. However, there is nothing in principle to prevent the participation of tax haven states in the development of IFL and, for the reasons already discussed, such participation would be of general benefit to the development of IFL. This matter is taken up again in the final part of this thesis.

CHAPTER 3 - NOTES

1 C. Doggart; Tax Havens and their Uses 1987, Economist Intelligence Unit, Special Report No. 1084, (London, 1987).

2 These historical details are derived from: United Nations, Department of International Economic and Social Affairs, "International Co-Operation in Tax Matters" (New York), 1984, SI/ESA/142, page 30 and from C. Doggart (op. cit at note 1 above) p. 1.

3 Note 2, Ibid.

4 For example, a Gibraltar "exempt company" may not carry on local activities as a condition of its exemption from Gibraltar income tax under the Companies (Taxation and Concessions) Ordinance.

5 Switzerland, a well known tax haven, is a good example of a tax haven with a very long record of such stability. Without this stability the security of the taxpayer's assets and investments cannot be relied upon and the tax haven will become markedly less attractive. An illustration of this is the Bahamas, which, as a tax haven, suffered badly from the unexpected election in the early 1970s of a new government which adopted a hostile attitude to the tax haven business (See further M. Grundy, The World of International Tax Planning (Cambridge, 1984), page 62). In consequence, a great deal of the business formerly carried on in the Bahamas was withdrawn and relocated elsewhere, in large part to the Cayman Islands and to a lesser extent to the British Virgin Islands, Gibraltar, and others.

6 The secrecy required may relate to the actual operations of a tax haven company, or to the owners of the company. Often, disclosure required for the purposes of annual returns or other financial information to local tax authorities is of a very limited extent in tax havens. Bank secrecy is another important element. Many tax havens do not permit the inspection of bank accounts by fiscal authorities, including both domestic and foreign fiscs. Indeed, a number of countries make it a criminal offence for bank employees to reveal information to which they have access. (For example, in the Cayman Islands a provision which has this effect is the Cayman Islands Bank and Trust Companies Regulation Law 1966, (Law No. 8 of 1966), s. 10.) The effect of such provisions is that it is often difficult to establish the legal persons involved in tax haven operations and to establish the transactions effected.

7 B. Spitz, International Tax Planning, (Butterworths, 1972) page 101.

8 This subject is covered in greater detail in W.H.Diamond and D.B. Diamond Tax Free Trade Zones of the World (New York, 1984).

9 See further; W.H. Diamond, "What to Look for when Choosing a Foreign Non-Tax-Haven Base" in "U.S. Taxation of International Operations" (Prentice Hall, 1981) 7631.

10 For example, the Administrator in Council of the Cayman Islands may grant a guarantee against direct taxes being imposed for a period of twenty years from the date of a company's incorporation, (Tax Concessions Law (No.s 20 and 21 of 1962) as amended). A longer period of fifty years is guaranteed if the taxpayer is an exempted trust, (Trusts Law (No 6 of 1967)).

11 See, for example, D W Williams, op cit at note 51 at p 162.

12 R.A. Gordon "Tax Havens and their Use by United States Taxpayers - An Overview", Report to Internal Revenue Service, 12 January 1981.

13 This is the categorisation favoured by the United Nations, even though the U.N. does appear to distinguish occasionally between acceptable and unacceptable tax haven operations. See note 2 Ibid page 32.

14 J. Huiskamp et al; International Tax Avoidance - A Study by the Rotterdam Institute for Fiscal Studies (Deventer, 1979) Volume A, page 72.

15 Marshall Langer has pointed out that: "An investor may establish a tax-haven company or trust to prevent the authorities in his country from knowing of assets and income he may have abroad. Sometimes this is done to avoid present taxes and controls. More often this is done to protect against the possibility of <u>future</u> taxes and controls or against possible <u>future</u> confiscation". M.J. Langer: How to Use Foreign Tax Havens, Practising Law Institute, (New York, 1975) page 11.

16 See further International Fiscal Association Seminar Paper "Recourse to Tax Havens - Use and Abuse" (Kluwer, 1980), page 76.

17 J. Chown, Taxation and Multinational Enterprise (London, 1974) Chapter 11.

18 For a fuller description of upstream loans, see Board of Inland Revenue; International Tax Avoidance (London, 1981) page 59 et seq.

19 See, for example, the comments in the recent O.E.C.D. paper dealing with tax havens (cited at note 22), paragraph 24-32, which also contain a fuller description of the operation of base companies.

20 See generally; T. Clarke and J.G. Tigue, Dirty Money, (Millington Books, 1975).

21 New Zealand Ministry of Finance, Consultative Document on International Tax Reform, December 1987, p.i.

22 O.E.C.D. Committee on Fiscal Affairs; Tax Havens: Measures to Prevent Abuse by Taxpayers, in International Tax Avoidance and Evasion, Issues in International Taxation No. 1, (Paris, 1987),

23 The O.E.C.D. comprises Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, The Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, The U.K. and the U.S.

24 Note 22, Ibid, paragraph 1.

25 Note 22, Ibid, paragraph 39.

26 "Tax Havens and their Use by United States Taxpayers - An Overview", by Richard Gordon, U.S. Department of Treasury, (1981).

27 "Tax havens in the Caribbean Basin" report by the U.S. Department of Treasury, (1984).

28 Note 22, Ibid. The escalation is clearly implied in paragraph 40, read together with paragraphs 41 and 42.

29 For the present, it is perhaps worth recording that even countries which target measures against tax havens accept this point. In the case of the U.K., see further Board of Inland Revenue, 'Tax Havens and the Corporate Sector" (June, 1982) para. 5.

30 ICTA 1988, s. 765 (formerly ICTA 1970, s. 482) which was partially abolished with effect from 15th March 1988.

31 In Australia, for instance, the Reserve Bank of Australia, which is responsible for administering exchange control, is required not to grant exchange control for most agreements with residents of certain designated countries listed in a notice under the Banking Act unless a tax clearance certificate has been issued by the Commissioner of Taxation.

32 Assuming a letter box company created by a U.K. parent, for example, a challenge by the U.K. fisc would in practice be based on one of two possible arguments that, in substance, the real business operations were carried on in the U.K.. The U.K. authorities might argue that such a letter box company was in reality resident for tax purposes in the U.K. on the basis that its "central management and control" (see further De Beers Consolidated Mines v Howe, 5TC 198) - ie. the highest level of executive authority of the company - was exercised in the U.K. or alternatively might argue that the company had - as a result, say, of activities carried out on its behalf in the U.K. by employees of other group companies - a taxable branch in the U.K.. The U.K. technical analysis would be different in each case (a company resident in the U.K. is taxable on its worldwide income -

ICTA 1985, ss. 6, 8, 11 - whilst a non-resident company with a taxable branch in the U.K. is taxable only on the profits attributable to that branch based on the rules in ICTA 1988, s. 11) but the result would probably be the same since the Inland Revenue would in such a case usually argue that the only profits of the company were those attributable to its U.K. activities so that all its profits should be subject to U.K. tax, whether it were resident in the U.K. or merely had a U.K. branch.

33 Income Tax Act 1976, s. 99.

34 Article 238A, Code General des Impots. See also the detailed Administrative Instructions of June 26th, 1975 (4C-8-75) which has specified the terms of application of Article 238A.

35 The U.K. legislation, for example, is that contained in ICTA 1988, sections 289 -312.

36 Note 22, Ibid, paragraphs 114-124.

37 It is occasionally objected that in reality the two different approaches cannot be distinguished in the broad manner adopted in the text. It is considered by the author that this objection is unfounded as economically different results may arise depending on whether CFC legislation is targeted at the type of income involved (broadly, whether active or passive) or whether at the location in which the CFC is based. However, it should be noted that the broad distinction is not an absolute divide. For example, the U.K. CFC legislation, as finally enacted, contains an "exempt activities" test (ICTA 1988, sch 25, para. s 5-12) designed to accommodate what may be referred to as genuine trading activities.

38 Professor L.J. Seidler, Everything You Wanted To Know About Tax Shelters, But Were Afraid To Ask (New York, 1981) page 5.

39 J. Van Hoorn, "The Use and Abuse of Tax Havens" in J. Avery-Jones (ed) Tax Havens and Measures against Tax Evasion and Avoidance in the E.E.C. (London, 1974).

40 J. Chown, Taxation and Multinational Enterprise (London, 1974) chapter 11.

41 J. Chown and M. Edwardes-Ker: "Tax Havens and Offshore Investment Centres", The Banker, May 1974, page 479.

42 Note 2, Ibid, page 30.

43 International Fiscal Association Seminar Paper, Recourse to Tax Havens - Use and Abuse (Deventer, 1980) page 15.

44 Note 14 above, Ibid, page 71.

45 R. Saunders, International Tax Systems and Planning Techniques (London, 1984) page 7001.

46 B. Spitz, International Tax Planning (Butterworths, 1972) page 82.

47 The Japanese classification is as follows:

(i) countries with low rates of taxation
(ii) countries with low rates of taxation on income from foreign sources
(iii) countries with low rates of taxation on income from specified business activities.

48 Professor V. Uckmar states "some tax havens are indeed more attractive because of the existence of certain bilateral tax conventions with industrialised countries, which permit the routing of income from world-wide sources". See General Report, Tax Avoidance and Evasion, IFA Cahier de Droit Fiscal International 68a (Kluwer, 1983), p.44.

49 As is discussed in more detail later in this chapter, it is not sufficient for states in this category merely to have a wide network of double tax treaties. It is in addition necessary that there is (1) limited or no withholding tax on incoming cash flows (though this is largely achieved through a favourable treaty network); (2) limited or no tax on the receipt of income under domestic law and (3) limited or no withholding tax on outbound cash flows.

50 Whether a foreign income tax is "similar" to the Dutch corporation tax under article 13(3) of the Corporation Tax Act is not always clear and in practice advance rulings on the status of remittances are obtained from the Dutch fisc.

51 The inclusion of the U.K. may seem somewhat surprising but, as the later discussion in chapter 6 will explain, there are good reasons for its inclusion - see further Economist Intelligence Unit, Britain as a Tax Haven, (London 1986. Britain is also referred to in the context of tax havens by Professor David Williams - see D.W. Williams, Trends in International Taxation (Amsterdam, 1991 p.163. It is well known that the U.K. is a particularly attractive state to non-U.K. domiciled individuals.

52 RD 118 of 1982, T-zones.

53 RD 187 of 1982.

54 Co-ordination Centres, Law of 27th December, 1984.

55 Note 22, Ibid.

56 ICTA 1988, ss 289-312. The Business Expansion scheme was abolished by F (No2) A 1992, s.38.

57 Note 22, Ibid, paragraph 77.

58 Note 22, Ibid.

59 Note 22, Ibid, paragraph 80.

60 Note 22, Ibid, paragraph 74.

61 Note 2, Ibid.

62 Note 2, Ibid.

63 Note 2 above, Ibid, at p.32.

64 The argument that CFC measures represent a breach of the fiscal sovereignty of the tax haven states affected by such measures is developed in the latter two chapters of this thesis. For the present, it is sufficient to note that such a breach of fiscal sovereignty will be avoided only if such taxation of CFCs is consistent with the widely - accepted relevant principles of IFL and (as considered throughout the first three chapters of this thesis) this appears not to be the case. Neither is it considered an adequate argument that because CFC legislation generally gives credit for overseas taxes paid by foreign subsidiaries of the companies in states operating that legislation, there is no effect on the "fiscal sovereignty" of the states in which these subsidiaries are located. If such states do not wish to levy taxation or wish to levy taxation at a reduced rate, there seems no sound reason why economic activity conducted in the CFC state by the subsidiaries affected should be taxed at levels of taxation in excess of the domestic rate. The credit mechanism (which in any event often works in a restricted manner - e.g. the U.K. rules for "branch" tax of CFCs) merely ensures that, to some extent, there is no double taxation <u>in addition</u> to a breach of fiscal sovereignty.

65 The manner in which the two are run together is reflected in the position taken by the O.E.C.D. Committee on Fiscal Affairs, which has stated that "International tax avoidance and evasion through the use of tax havens is one of the most important and long-standing concerns of the tax administrations of most O.E.C.D. countries" (see note 22, Ibid).

66 United Nations, Dept of International Economic and Social Affairs, "International Co. Operation in Tax Matter". (New York, 1984).

67 Note 66, Ibid, at paragraph 203.

68 Note 66 Ibid, at para. 27.

69 There are many examples of the tendency by fiscal authorities to equate use of a tax haven with abuse of a domestic tax system. This was one of the

major assumptions implicit in the Gordon Report (see note 25 above). A more recent example is contained in the O.E.C.D. paper entitled "Tax Havens: Measures to Prevent Abuse by Taxpayers" (cited at note 22 above), paragraphs 39-45.

70 See, for example, L.E. Wenehed and W.G. Kuiper, "High Tax Countries: an Alternative for Tax Havens?", European Taxation, (April, 1988), pp. 103-107.

71 In chapter one it was pointed out that the development of IFL is at a relatively nascent state and that, for example, the principles are not yet sufficiently accepted and defined on an international basis for a multilateral double tax convention to be a practicable possibility. Whilst there is no broad and detailed consensus on all aspects of the principles of IFL, this does not invalidate the comments made in the text on the acceptability and suitability of the relevant principles of IFL (taxable nexus, residence and arm's length principles) to act as the relevant criteria in the situation discussed. These principles of IFL <u>are</u> widely accepted by states, as evidenced by the fact they are central to most double tax agreements.

72 For example, partly in response to concerns about the use of offshore centres for money laundering purposes, on October 5th and 6th 1992, twenty-six governments of the Caribbean Financial Action Task Force (CFATF) agreed to adopt a number of important measures against international money laundering, including the provision of information to third countries and international regional organisations (see the journal Offshore Investment issue 33, January 1993, at pp 4-5). Of more direct relevant to tax issues are the recent tax treaties between the U.S. and the Cayman Islands and the U.S. on Bermuda. The U.S. Cayman Islands treaty, signed on 3 July 1986, provides inter alia, for the two countries to co-operate in each other's investigations into tax crimes arising from the profits of certain criminal matters covered by the treaty. The U.S. and Bermuda treaty, signed on 11 July 1986, pledges Bermudian co-operation in U.S. civil and criminal tax investigations. The treaty has been described as "a real breakthrough" for the U.S. by Roger Olsen, the assistant attorney general of the U.S. Justice Department's tax division (see further, Tax Planning International, Vol. 13, No. 8 (August 1986) p. 33).

PART B

CONSIDERATIONS RELATING TO THE UNITED STATES OF AMERICA

CHAPTER 4

THE APPROACH TO TAX AVOIDANCE, ATTITUDE TO TAX HAVENS AND U.S. ANTI-AVOIDANCE LEGISLATION

INTRODUCTION

This chapter deals with the official approach in the U.S. to the topics of tax avoidance (particularly international tax avoidance) and tax havens. Following the analysis of the above, there is a discussion of a variety of general U.S. anti-avoidance measures. The chapter then examines the "hexapus", a series of legislative measures directed at preventing corporate tax-free accumulations. The chapter closes with an overview of the detailed controlled foreign corporation (Subpart F) legislation.

THE APPROACH TO TAX AVOIDANCE

In theory, there is in the U.S. a distinction between tax avoidance and evasion:

> ""Tax evasion" in the U.S. involves a wilful violation of the law to escape the payment of a tax. A finding of an intent of wilful evasion may subject a taxpayer to civil and criminal fraud penalties, including imprisonment. By contrast, "tax avoidance", broadly construed, includes all tax minimisation techniques not deemed to constitute tax evasion".[1]

Inevitably, however, the purported distinction is subject to those difficulties discussed in detail in the earlier chapter on international tax avoidance so that it is not surprising to discover that authors of the above explanation later concede:

> "Given that there is no clear line between legitimate tax avoidance or minimisation behaviour and unacceptable minimisation schemes, taxpayers and their counsel are frequently unable to distinguish between the two".[2]

There exist also the difficulties of distinguishing avoidance transactions or activities which are permitted by the fisc and those which are not, i.e. the distinction between "acceptable" and "unacceptable" tax avoidance.

Untroubled by these difficulties, the U.S. fisc has devoted considerable resources to the fight against both domestic and international tax avoidance. In its legislation, administration, litigation and treaties a number of techniques have been adopted to counter avoidance devices.

With regard to legislation, detailed and aggressive statutory provisions have been passed on a large number of occasions with the sole intention of preventing tax avoidance. These provisions are almost invariably backed up by even more complicated and extensive regulations having general application.[3] Some of these provisions will be considered below.

In general, the U.S. fisc has been able to rely on the support of the courts where cases involve transactions or activities engineered for tax avoidance purposes. The courts have developed a number of anti-avoidance doctrines to thwart what are deemed unacceptable tax avoidance schemes. Transactions involving the use of tax havens may be subject to challenge in the courts under these doctrines.

It is difficult to define these doctrines precisely as the various theories underlying them tend to converge.[4] The "business purpose" doctrine is used to attack transactions which have been entered into solely for tax avoidance purposes. The absence of a business purpose may cause the transactions to be disregarded for tax purposes, notwithstanding literal compliance with the tax statute. The leading case in this area is Gregory v Helvering.[5]

Under the "substance over form" theory, the courts may look to the substance or economic effect of a transaction and ignore the form in determining tax liability.[6] A similar doctrine is the "step transaction" theory under which two or more artificially separate steps may be amalgamated and treated as a single or

composite transaction directed at a particular end result. It is arguable that this theory is merely an aspect of the substance over form doctrine since courts often need to establish the substance of the transaction in deciding whether to apply the doctrine. Under the "sham" transaction doctrine, the court will deny the tax effect of a transaction if, although complying with the literal terms of the statute, the transaction is in fact a sham.[7]

Finally, there is the "assignment of income" doctrine under which the court may examine the labour or capital which produced an income stream in order to identify the appropriate taxpayer to whom to attribute the income for tax purposes. The doctrine is usually applied where a person who has earned income assigns his rights to it to a third party.[8]

It appears that there is no underlying principle unifying these various doctrines.[9] Taken as a whole, these broad and relatively subjective anti-avoidance doctrines may be used in the courts by the fisc to great effect in denying the tax effect of, inter alia, tax haven transactions.

The policy of the U.S. in vehemently opposing international tax avoidance activity and the use of tax havens is also manifested in its tax treaty policy. The treaty policy of the U.S. has been publicly explained by Treasury representatives as follows:

> "it is the policy of this Administration [the Reagan administration] not to enter into new treaties which permit the unwarranted granting of benefits to residents of third countries and, as appropriate, to negotiate, or, if necessary, to terminate, existing treaties to accomplish this objective.[10]

All U.S. treaties negotiated in recent years contain anti-treaty shopping measures. Since 1977 all treaties entered into by the U.S. contain the "beneficial owner" principle with regard to remittances of U.S. source interest, royalties and

dividends. Under this principle reduced treaty withholding rates will not apply if an intermediary entity is interposed between the U.S. payer and ultimate beneficiary unless both the intermediary and ultimate beneficiary are residents of the treaty country.[11]

In Article 16 of its Model Tax Treaty, the U.S. has expanded upon Article 10 of the 1977 O.E.C.D. Model Convention which concerns disallowance of withholding rate reductions on dividend remittances to foreign holding companies. Article 16, entitled "Limitation on Benefits",[12] is perhaps the harshest anti-abuse provision in existence with regard to treaty shopping. The article denies treaty benefits to a corporation unless:-

(a) it is not controlled by persons resident outside the Contracting State other than citizens of the U.S.; and

(b) the income of the corporation is not applied in substantial measure, directly or indirectly, to meeting the liabilities of such persons; or

(c) it did not have as a principle purpose the obtaining of treaty benefits.

The exchange of information and mutual assistance provisions contained in the U.S. tax treaties are actively used by the IRS to exchange information about transactions and activities of taxpayers. The U.S. also engages in simultaneous examination procedures whereby the U.S. and a treaty partner simultaneously audit the affairs of designated taxpayers with a co-ordinated exchange of information. The main benefit of this approach is that it allows each country to examine the relevant transactions from both sides and at the same time.

The increasingly aggressive treaty policy of the U.S. is reflected by its termination in 1982 of its tax treaty with the British Virgin Islands. This treaty had become notorious for its use by treaty shoppers. Following the unacceptability of Article 16 to the British Virgin Islands negotiators, the U.S. gave formal notice that the

treaty was to be terminated in pursuance of its policy to limit treaty benefits to those legitimately entitled.

In conclusion, there is a very clear intention in the legislation, administration, and tax treaty policy of the United States, as well as in judicial proceedings initiated by the fisc, to prevent a wide variety of forms of avoidance activity in order to ensure the intended functioning of the U.S. tax system. However, as will be seen, this policy is only one of several U.S. policies and there appear to be significant difficulties in satisfactorily reconciling the various (and competing) objectives arising from these different policies in a manner which results in the application of a co-ordinated and coherent anti-avoidance strategy. This is particularly so as regards anti-avoidance measures in the field of international, rather than merely domestic, tax avoidance. The clash of policy objectives is discussed more fully below.

THE ATTITUDE TO TAX HAVENS

The concept "tax haven" is nowhere defined in either the Internal Revenue Code or in the Regulations which apply to it. However, although the concept is not actually referred to in the tax legislation,[13] a number of legislative provisions have been designed with tax havens in mind and there is much official pronouncement on tax abuses being facilitated by the existence of tax havens.[14] The concept is therefore of some importance, although discovering the criteria used by the fisc to establish tax haven status remains difficult. It would appear that Internal Revenue Service sources have indicated that, although no precise definition of a tax haven exists, the term will be appropriate to certain countries which possess one or more of the following characteristics:[15]

1) either impose no tax or impose a low tax when compared with the U.S.;

2) have a high level of bank or commercial secrecy which the country refuses to break even under an international agreement;

3) recognise the relative importance of banking and similar financial activities to its economy;

4) have modern communications facilities available;

5) do not impose currency controls on foreign deposits or foreign currency; and

6) engage in self-promotion as an offshore financial centre.

The approach of the U.S. fisc to tax havens is the subject of a 1981 U.S. Treasury Department report entitled "Tax Havens and Their Use by the United States Taxpayers - An Overview".[16] The report is more conveniently referred to as the Gordon Report after its author, Richard Gordon. The Report was commissioned by The Oversight Subcommittee of the House of Representatives' Ways and Means Committee following two days of hearings on the use of tax havens by Americans. Certain aspects of this influential Report have been considered already in the earlier chapter dealing with tax havens.

The stated aim of the Report is to provide an overall view of tax havens and their use by U.S. tax payers as well as providing suggestions as to how the fisc might in future regulate the use made of havens by U.S. tax payers. The Gordon Report considers mechanisms of international tax avoidance which date back to 1921 but observes that concern on the part of the Fisc relating to the use of tax havens by U.S. tax payers has existed only since the mid 1950s.

This is not strictly true since, as will be seen, the IRS was concerned as early as the mid 1930s about the use of tax havens by Americans. It is probably true to say, however, that the pattern of use of tax havens has undergone a fairly significant change since that time. Whereas the fisc's early concern related to the use made of tax havens by U.S. citizens and residents, its emphasis in more recent years has switched to concern over the use of tax havens by multinational corporations. This is principally due to the much larger monetary amounts that

are involved in the transactions of multinational corporations and the relative ease with which a group of companies with a multinational structure can employ the techniques of profit diversion and profit extraction. This shift of emphasis took place in the 1950s.

The Gordon Report explains tax havens to be, broadly, states with low tax rates compared to rates prevailing in the U.S. and a relatively high level of bank or commercial secrecy which is generally not breached even under international agreement.[17] Statistics are given to demonstrate the growing involvement by U.S. persons in tax havens and it is stated that the use by U.S. taxpayers of havens as a site for foreign corporations has increased faster than worldwide foreign activity. For example, U.S. Commerce Department data indicated that in the period from 1968 to 1978 direct investment in U.S. controlled tax haven business increased five fold, from $4.7 to $23 billion, while direct investment levels in non-tax haven business during that period grew from $57.2 to $145.1 billion, an increase of approximately two and one half times.[18]

Although the conclusions drawn by the Report are open to debate, it is certainly clear that the Gordon Report demonstrates anxiety on behalf of the U.S. fisc that the use of tax havens by U.S. tax payers requires very careful monitoring and, it is stated, corrective measures to prevent abuse. These statements in the report confirm the view that the U.S. does not wish to eliminate entirely the use of tax havens by U.S. taxpayers, but merely wishes to regulate such activity. The Report suggests three types of approach that could be adopted to fight tax haven usage. In view of the undoubted significance of the Gordon Report and the degree of development (and hence influence) of the U.S. anti-tax haven measures generally, these suggestions for future tax policy in respect of tax havens are of some importance. The three types of approach suggested are as follows:

1) Options that can be adopted administratively.

a) Requirement that records and books of foreign subsidiaries are made easily available to the IRS.

b) Requirement that deductions, valuations, pricing, etc is more thoroughly substantiated by the taxpayer.

c) Introduction of simplified transfer pricing rules and reduction in lengthy and complicated audits.

d) Consideration of unauthorised use of treaties.

e) Simplification of reporting obligations placed on taxpayer and enhancement of value of reporting requirements to the IRS.

f) Improved international co-operation.

g) Expansion of international tax training given to IRS staff.

h) Improvement of information channels.

2) Legislative options.

a) Expansion of Subpart F (U.S. anti-tax haven legislation) to add a jurisdictional test that would tax U.S. shareholders of a controlled foreign corporation formed in a tax haven on all of its income (rather than on some items of its income as at present).

b) Addition of a management and control test to the present jurisdictional test for subjecting corporations to U.S. tax to bring within the U.S. tax jurisdiction businesses which are in fact run in or from the U.S.

c) Simplification of taxation of tax haven income, combining the Foreign Personal Holding Company provisions with Subpart F (this legislation is discussed below).

d) Withdrawal of deductions for tax haven transactions unless adequate evidence is provided by the taxpayer.

e) Imposition of penalties, etc to discourage avoidance devices.

3) Treaty options.

a) Termination and renegotiation of treaties where necessary.

b) Conclusion of treaties only where necessary for trading purposes and never with tax havens.

c) Aim for exchange of information provisions which override domestic bank secrecy laws and practices.

d) Periodic review of operation of treaties in existence to ensure that they serve the purpose for which they were initially negotiated.

e) Pursuance of mutual assistance treaties with important tax havens.

f) Encouragement to abusive tax havens to enter into exchange of information agreements with the U.S., possibly by adopting measures to increase taxes on payments to these havens.

g) Limitation of abuse of treaties by incorporation of strong provisions to limit the use of treaties to residents of a treaty country.

It is clear from a consideration of the above measures (which are put forward as serious possibilities to combat perceived abuses involving tax havens by U.S. taxpayers), together with the Gordon Report as a whole, that U.S. tax policy is decidedly against tax haven use. However, it is noted that a wholly uncompromising and aggressive policy against tax havens by the U.S. authorities would interfere with other general policy objectives such as the following which are set out in the Report:[19]

1) Maintaining the competitive position of U.S. businesses investing abroad, exporting, or otherwise competing with foreign businesses.

2) Maintaining tax equity as between investment in the U.S. and investment abroad.

3) The need to provide fair rules for taxing foreign investment.

4) Administrative efficiency.

5) Foreign policy considerations including political or diplomatic relations with tax haven countries.

6) Promotion of investment in the U.S.

The Report recognises that, in practice, U.S. tax policy is ambivalent, representing unresolved conflicts between the types of policy objectives listed above:

> "The result has been policy ambiguities and compromises in legislation which have failed to resolve these conflicts, and which have left U.S. law without a clear focus with respect to tax havens. Concern for administrative feasibility has been nonexistent."[20]

By reason of these unresolved conflicts, the U.S. Congress has never sought to eliminate wholly tax haven operations by U.S. taxpayers. Instead, specific abuses have been identified and legislation passed to eliminate them. The result is a patchwork of anti-avoidance provisions, some specifically relating to tax havens (but nonetheless of general application) and some intended to deal with more general abuses. There is still no provision in the Internal Revenue Code which on its face deals specifically and exclusively with tax havens per se notwithstanding the fact that tax haven abuse in general has long been perceived by the U.S. fisc as requiring corrective measures.[21]

Richard Gordon states that nowhere is the tension between the differing policy objectives more apparent than when it is focused on tax havens:

> "Nowhere is the failure to resolve the policy issues more obvious. Congress over the years, while maintaining deferral of tax on the earnings of foreign corporations controlled by U.S. persons, has at the same time passed numerous anti-avoidance provisions generally

intended to solve perceived tax haven related problems. All have numerous exceptions, have been complex and difficult to administer and all have had gaps (many intended, some not)."[22]

This theme is of some importance and will be re-examined in the particular context of the passing of the 1962 U.S. CFC legislation below.

U.S. ANTI-AVOIDANCE LEGISLATION

For reasons of available space, the patchwork of numerous anti-avoidance provisions to which reference has been made cannot be considered in detail. However a number of the more important general provisions will be surveyed relatively briefly before a discussion of the main measures directed against overseas accumulations, including an explanation of the U.S. Controlled Foreign Corporation (Subpart F) legislation.

1 Transfer pricing legislation - section 482

Section 482 of the Internal Revenue Code is the main U.S. provision directed against abusive transfer pricing practices. The section provides a very broad power to re-allocate income, deductions, credits and allowances between related parties on an arm's length basis so as to prevent avoidance of tax. A version of the section has had statutory force since 1921.[23] Though the section has undergone several amendments since that time,[24] its overall tenor has remained unchanged so that it is still true to say that the:-

> "Intention of Congress... since 1921 was to prevent corporations from taking advantage of separate corporation structures all within the same corporate family to diminish the overall tax liability of the family through the use of various kinds of inter-

> corporate transactions which served no business purpose other than the reduction of the family's total tax liability".[25]

The section prevents a shifting of income or deductions between related parties in order to benefit from differentials in tax rates. Although this may arise in a domestic context, it is more usual to associate section 482 reallocations with international transactions, often involving foreign related parties in tax haven jurisdictions.

In the international setting, section 482 fulfils a secondary role of protecting what is perceived by the tax authorities as the United States' appropriate share of tax revenues in international transactions. Even where international inter-company transactions result in no overall reduction in the tax burden on the multinational group as a whole, the IRS can invoke section 482 to allocate income to the U.S., thus ensuring an appropriate proportion of the profits arising on the transaction are subject to U.S. taxation.

Although section 482 appears to be a deceptively simple provision containing only two sentences in its statutory expression,[26] the section is supported by complicated Regulations which were adopted in April 1968. The regulations deal not only with prices for products but also with royalties, loan interest, services and other income paid or received by U.S. foreign corporations. Additional Regulations concerning service payments were added in 1969.[27]

There is no doubt that section 482 is one of the most important U.S. anti-avoidance provisions in the Code.

In 1979 the tax value of section 482 adjustments proposed by international examiners was $500 million which represented 36% of the tax value of all adjustments proposed by the international examiners.[28]

2 Foreign Source "Effectively Connected" Income

The Internal Revenue Code was amended in 1966 to prevent the effective use of the United States as a tax haven by foreign companies selling through U.S. offices without reporting the U.S. activity as taxable.

Certain foreign-source income can now be treated as effectively connected, and therefore taxable, if a U.S. office contributes significantly to the selling activity.[29]

3 S. 269 Internal Revenue Code

S. 269 permits the Secretary of the Internal Revenue Service to disallow a tax benefit if the principal purpose of the acquisition of control of a corporation is evasion or avoidance of federal income tax by securing a tax deduction, credit or other allowance which would not otherwise arise.[30] This provision applies to foreign corporations as well as domestic corporations.[31]

4 S. 367 Internal Revenue Code

Under U.S. law a number of transactions involving the formation and reorganisation of corporations are accorded "non-recognition" treatment.[32] This means that immediate recognition of any gain arising is deferred and the taxpayer is taxed only when the stock or other property received in the transaction is disposed of at some future date. In 1932 Congress recognised that these Code provisions could be used to transfer property beyond the

U.S jurisdiction and thus constituted a "serious loophole for the avoidance of taxes".[33]

For reorganisations involving transfers from the United States to foreign corporations, section 367 requires the taxpayer to obtain a ruling within 183 days of the transfer occurring that the transaction does not have as one of its principal purposes the avoidance of Federal income taxes. If such a ruling is not obtained non-recognition treatment will not be available.[34]

5 S. 1491 Internal Revenue Code

The original version of s. 1491 was also enacted in 1932 and, like s. 367, was designed to prevent tax avoidance by the transfer of property to an entity outside the U.S. jurisdiction. Section 1491 imposes an excise tax at the rate of 35%[35] on any appreciation inherent in any property which is transferred by U.S. persons (including domestic corporations) to a foreign corporation as a contribution to capital or to a foreign partnership, trust or estate.

The excise tax does not apply to a transfer described in s. 367[36] or to a transfer for which an election has been made under section 1057.[37] Under s. 1057 the taxpayer may elect to treat a transfer described in s. 1491 as a taxable sale or exchange and thus recognise a gain equal to the excess of the fair market value of the property transferred over its adjusted cost basis for the purposes of determining the gain.

The excise tax will not be payable if it is established before the transfer to the satisfaction of the fisc that the transfer is not in pursuance of a plan which has as one of its principal purposes the avoidance of Federal income taxes.[38]

6 Information Returns

One of the notable features of the U.S. tax system is the depth of reporting required of resident taxpayers. The Internal Revenue Code requires numerous information returns relating to the activities of U.S. taxpayers in foreign tax havens. For example, in relation to transfer pricing, Form 5471 must be completed each quarter and state the relationship between the U.S. taxpayer and the foreign affiliate as well as details of all relevant transactions and shareholdings. Failure to comply with the requirement may lead to a civil penalty of up to $10,000 and imprisonment of those responsible for up to one year.[39]

The immense amount of information required by the IRS provides an additional disincentive to tax haven activity.

THE HEXAPUS (formerly Pentapus)

Whilst the foregoing measures may be applied generally to combat perceived cases of international tax avoidance, there are now six sets of rules which attempt to combat the use of corporate entities for the purpose of accumulation. Four of these are specifically directed at overseas entities.

These rules, and the years in which they were first enacted, are as follows:-

1. Accumulated Earnings Tax (1913).

2. Personal Holding Company (1934).

3. Foreign Personal Holding Company (1937).

4. Foreign Investment Company (1962).

5. Controlled Foreign Corporations (Subpart F) (1962).

6. Passive Foreign Investment Company (1986).

Each set of rules is extremely complex in itself. The relationship of each set of rules to the other sets of rules raises further complications. In many ways, the very existence of these highly complex and unco-ordinated rules which, broadly, seek to attack similar types of perceived abuses is a prime example of the wholly unsatisfactory "patchwork" approach to anti-avoidance legislation in the U.S. This is, presumably, the observation of Professor Harvey Dale of the New York University Law School who (prior to the introduction of the Passive Foreign Investment Company provisions in 1986) coined the term "pentapus" to describe the first five sets of rules, drawing an analogy between them and a sea monster with five wholly uncoordinated tentacles.[40] With the introduction of the PFIC rules, the term "hexapus" has now been introduced.[41]

This series of rules is of relevance to this chapter for a number of reasons. First, it places the controlled foreign corporation (Subpart F) rules in their historical and legal context in terms of legislation specifically promulgated to prevent corporate accumulations. Second, there is a clear relationship between the various sets of rules; for example, one of the more significant types of income subject to the subpart F provisions is based on Foreign Personal Holding Company income. Third, the very development on a piecemeal basis of a number of anti-avoidance measures (which together comprise the hexapus) reflects the approach adopted by the tax authorities in dealing with perceived tax avoidance by means of corporate accumulations. The rules will be discussed in chronological order.

1. <u>Accumulated Earnings Tax</u>

Sections 531 to 537 of the Code provide the fisc with a mechanism to tax "unreasonably accumulated" income. Given that the U.S. operates a "classical" system of corporation tax whereby corporate earnings are taxed

at both corporate level and then in the hands of shareholders on distribution, the retention of profits in a U.S. corporation could, in the absence of this tax, result in either a reduction or deferral of the total tax burden. The imposition of the Accumulated Earnings Tax was designed to discourage such accumulations.

The Accumulated Earnings Tax was the earliest anti-abuse measure, being introduced with the income tax by the Revenue Act of 1913. As originally framed, where a corporation was "formed or availed" to accumulate income, each shareholder's rateable share of the corporation's profit would be taxed as if distributed to the shareholders.[42] The law was amended in 1921 to impose a penalty tax on a corporation when it unreasonably accumulated earnings for the purpose of avoiding the income tax charge on its shareholders rather than distributing those earnings.[43] Section 533 of the Code states that the purpose of avoiding the income tax on shareholders is to be determined by whether the earnings and profits of a corporation are permitted to accumulate "beyond the reasonable needs of the business".[44]

The determination of the "reasonable needs of the business" is dealt with in the Treasury Regulations.[45] An involved inquiry into all aspects of the corporation's business will be required and a number of factors, such as plans for expansion, replacement of business assets, provision of working capital, will be taken into account.

It should be noted that the Accumulated Earnings Tax base includes only U.S. source income and income "effectively connected" with a U.S. trade or business. The Accumulated Earnings Tax applies to neither Personal Holding Companies nor Foreign Personal Holding Companies.[46] Both types of companies are described below.

The legislation does not specifically deal with the application of the Accumulated Earnings Tax to foreign corporations. The wording of Section 532(a) suggests, and the Regulations confirm[47], that the Section will be applicable to foreign corporations which have U.S. source income if any of the shareholders of the corporation would be subject to U.S. income tax on the distributions to the corporation by reason of being:

(a) citizens or residents of the United States;
(b) non-resident alien individuals subject to the federal income tax;
(c) foreign corporations in which beneficial interest is owned directly or indirectly by any shareholder described in (a) or (b) above.

However, it would appear that the IRS does not actively pursue the application of the Accumulated Earnings Tax to foreign corporations.[48]

The fundamental concept of the Accumulated Earnings Tax, is that of "unreasonably accumulated" income, which is both broad and highly subjective. For this reason, the effect of the legislation is in a large part determined by the way the IRS have sought to apply it. The history of the provisions demonstrates the difficulties this inherent subjectivity has caused. When the provision first appeared in 1913, it was designed to prevent the fraudulent use of companies for the purpose of evading taxes. The requirement of fraud was eliminated in 1918[49] because this requirement was found to weaken the effect of the Statute. This was because, as the Senate Finance Committee observed, proof of fraudulent intention is very difficult to establish:

> "The section of the present law .... providing that undistributed profits of a corporation may in certain cases be treated as part of the income of its stockholders subject to surtax, has proved to be of little value because it was necessary to its application

> that intended fraud on the Revenue be established in each case".[50]

Tax legislation requiring the fisc to determine the commercial acceptability and necessity of corporate actions will often prove unpopular in practice since the taxpayer will inevitably feel the fisc are not qualified to make such a decision. No doubt such frictions arise in practice with regard to the determination of "unreasonably accumulated" income.

The Accumulated Earnings Tax has, over a long period of time, been the subject of some controversy between the Treasury Department and Congress. As early as 1924, the Treasury were complaining about the ineffectuality of the law.[51] At the same time Congress, on the other hand, had quite contrary concerns relating to the impact of the tax as an unreasonable burden on business. It was argued that the tax would penalise taxpayers for having done nothing wrong; prevent business building up surpluses for the purpose of expanding; and affect legitimate businesses as adversely or more adversely than those trying to avoid tax.[52]

Again, in 1954, the Ways and Means Committee observed:

> "Your Committee has received numerous complaints that the provision is prejudicial to small businesses, that it has been applied in an arbitrary manner in many cases, and that it is a constant threat to expanding business enterprises. Fear of the penalty tax is said to result frequently in distribution of funds needed by the corporation for expansion or other valid purposes".[53]

The conflicting attitudes to the legislation of the Treasury Department and Congress demonstrate the extent to which differing policy objectives may prove difficult to reconcile in practice.

2. Personal Holding Companies

The Accumulated Earnings Tax attacks the accumulation at corporate level by corporations in general. Sections 541-547 of the Code impose a special penalty tax on the undistributed income of a particular class of corporation, Personal Holding Companies (PHCs). The rules were promulgated specifically to deal with the "incorporated pocket book", a scheme which was "perhaps the most prevalent form of tax avoidance practised by individuals with large incomes".[54] The incorporated pocket book scheme worked by interposing a corporation between the tax payer and his passive income. Without the intervention of the corporate entity, the passive income would have been taxed directly in the hands of the taxpayer. These Personal Holding Company provisions were apparently necessary because the Accumulated Earnings Tax could not prevent all the perceived abuses in this area:[55] Since the Accumulated Earnings Tax provisions attack unreasonable accumulations by corporations, they could not be used where the U.S. fisc wished to deter the very existence of certain types of corporate income, regardless of whether or not the corporation has unreasonably accumulated income.

The PHC provisions have a clear target and are more precise than the Accumulated Earnings Tax: unlike the subjective criteria relating to that tax, the PHC provisions apply if and only if certain objective conditions are met.

The provisions, which were added to the law in 1934 and extensively revised in 1937 and 1964, were intended to thwart the creation and use of certain closely-held corporations deriving a substantial part of their income

from PHC source income which includes income from passive investment, interest, royalties, estates, trusts, rents (unless rents constitute more than 50% of adjusted ordinary gross income) and the performance of personal services by a substantial shareholder.[56] It is for this reason that the definition of a PHC is framed with reference to stock ownership and type of income.[57]

A corporation is a PHC if at least 60% of its adjusted gross ordinary income is PHC income (as described above) and more than 50% in value (rather than control) of its stock is owned by 5 or fewer individuals at any time during the last half of its tax year.[58] Stock ownership is determined by reference to a complex set of attribution rules[59] which are similar but not identical to the attribution rules under Subpart F, which will be discussed later in this chapter.

Since most U.S. closely-held corporations will fall within the stock ownership test, it is usually the presence of PHC income that determines whether such corporations are subject to these provisions. PHC status may also be achieved inadvertently by ordinary trading companies which achieve low trading profits and also receive certain passive income.

The undistributed PHC income of a PHC is subject to an additional penalty tax at the rate of 28%. The rate was until recently a highly punitive 70%.[60] The PHC provisions are designed to force distribution of PHC income to the shareholder in whose hands it will be subject to income tax at graduated rates. The tax is imposed on the corporation and not the shareholders.

The PHC provisions do not apply to banks, insurance companies, and finance companies if they are conducting an active business, even though receiving various types of PHC income.[61]

A foreign corporation can be a PHC if it meets the criteria set out in sections 541-547. However, whilst the foreign corporation can be subject to the PHC rules, the application of the rules will be restricted to its U.S. source PHC-type income because under section 882(b) of the Code the gross income of a foreign corporation includes only U.S. source income.

Even where the foreign corporation enjoys U.S. source income, the PHC rules will not apply if all the shareholders are non-resident alien individuals. If the U.S. ownership of stock amounts to less than 10% the PHC penalty tax is in effect limited to the U.S. shareholders' proportionate interest in the corporation.[62] Where the 10% threshold is exceeded, this pro rata limitation does not apply and the PHC tax is applied in full.

3. Foreign Personal Holding Companies

Three years after the enactment of the PHC provisions, and following a request of President Roosevelt and the report of the Joint Committee on Tax Evasion and Avoidance of the U.S. Congress, Congress again acted against "incorporated pocket books". The Joint Committee had observed that tax avoidance efforts were "so widespread and so amazing both in their boldness and ingenuity" that action was immediately necessary to contain the abuses.[63] One of these tax avoidance devices was pointed out to be;

> "the device of evading taxes by setting up foreign personal holding corporations in The Bahamas, Panama, Newfoundland and other places where taxes are low and corporation tax is lax"[64]

The principal reason behind the success of this method of tax avoidance was the inability, through lack of jurisdiction, of the U.S. fisc to impose the PHC penalty tax on such foreign corporations. The Foreign Personal

Holding Company (FPHC) provisions were a radical response to the perceived problems. Based on the fact that the foreign company itself was beyond the U.S. jurisdiction but that the controlling shareholders (who were U.S. residents or citizens) were within that jurisdiction, the new proposal put forward was that the shareholders would be taxed pro rata on the income of Foreign Personal Holding Companies, whether or not such income was actually distributed to them. The justification for this "departure from accustomed methods" was stated to be:

> "the necessity of protecting the integrity of our revenue system by effectively closing one of the most glaring loopholes now existing"[65]

The Senate recognised the radical nature of this new method but nonetheless expressed itself to be satisfied with its necessity and justification:

> "your committee is of the opinion that it is justifiable on all grounds, including constitutional grounds, to provide for a method of taxation which will reach the shareholders who own stock in such companies and over whom the United States has jurisdiction."[66]

This approach of attributing to shareholders their pro rata share of earnings in a foreign corporation is followed in the Subpart F legislation which was enacted twenty-five years later.

FPHC provisions, therefore, are directed against pocket book companies which have been incorporated abroad by U.S. persons.[67] As has been seen, a foreign corporation can be subject to the PHC rules under sections 541 to 547 of the Code. This means that a foreign corporation can be subject to the PHC rules or to the FPHC rules or to both sets of rules, in

which latter case section 542(c)(5) of the Code dictates that the FPHC rules prevail. However, the Subpart F rules take precedence over the FPHC provisions.[68]

The PHC rules impose a penalty on corporations in respect of their accumulations. The FPHC rules, on the other hand, tax the U.S. shareholders of the foreign corporation directly on its undistributed income. In this sense the FPHC rules are the forerunner of the 1962 Subpart F legislation.

A foreign corporation is a FPHC if at least 60%[69] of its gross income for the year is Foreign Personal Holding Company Income (FPHCI) and if more than 50% in value of the corporation's stock or voting power is owned directly or indirectly by not more than five individuals who are citizens or residents of the U.S..[70] If a foreign corporation meets these conditions its U.S. shareholders are taxed on their proportionate share of undistributed FPHCI.[71] Complicated attribution rules apply for the purpose of determining whether the stock ownership requirements are met.[72] The definition of FPHCI is similar but not identical to PHC income. FPHCI is defined in section 553 and includes income from dividends, interest, royalties, estates and trusts, certain personal service contracts, rents (unless constituting 50% or more of gross income), net gains from the sale of securities, futures transactions and certain commodities and also compensation for the use of corporate property by shareholders owning 25% or more of the stock of the corporation.

FPHCI also includes the undistributed FPHCI of a subsidiary FPHC in which the parent FPHC hold shares. The income attributed to the parent is taken into account in calculating the parent's gross income for the purpose of the 60% gross income test.[73]

4. Foreign Investment Companies

The Revenue Act of 1962 adopted sections 1246 and 1247 as a means of attacking foreign investment companies. Prior to 1962, such companies avoided PHC or FPHC status by selling shares widely among U.S. person. A foreign investment company could, prior to 1962, be created in a tax haven and invest in non-U.S. securities or similar assets and accumulate income offshore. Section 1246(b) defines a Foreign Investment Company as a company of which more than 50% in vote or value of its stock is owned directly or indirectly by any number of U.S. persons at any time and whose business is primarily trading in securities.

The general rule of section 1246[74] is that any gain received by the taxpayer on the sale or redemption of his stock in a foreign investment company will be treated as ordinary income to the extent of his rateable share of its earnings accumulated after 1962 and during the time the shareholder held the stocks.[75]

The Foreign Investment Company provisions are generally aimed at portfolio investors and therefore, whilst the provisions are of some relevance to the present discussion, they need not be discussed in any further detail here.

5. Controlled Foreign Corporations (Subpart F)

The Subpart F provisions are discussed later in this chapter and for present purposes a very brief introductory summary will suffice.

The objective of the 1962 Subpart F legislation is to tax U.S. shareholders of controlled foreign corporations (CFCs) on their proportionate share of certain categories of the undistributed profits of such corporations.[76]

A CFC is, broadly, any foreign corporation which is owned as to more than 50% by United States shareholders.[77] Any United States person, including a domestic corporation, can qualify as a United States shareholder if it owns 10% or more of the foreign corporation's voting stock.[78] Therefore, all wholly-owned foreign subsidiaries of U.S. parent corporations automatically fall within the definition of a CFC.

Certain earnings of the CFC are attributed pro rata to the principal United States shareholders in the year in which they are earned by the corporation, provided such shareholders control the foreign corporation for an uninterrupted period of 30 days or more during its tax year. If the profits are subsequently distributed by way of dividend, no further tax is imposed. However, it is only the "tainted" income of the CFC which is attributed to U.S. shareholders in this way: the non-tainted income of the CFC will not be subjected to U.S. tax until it is repatriated to the U.S. Tainted Subpart F income includes: Foreign Personal Holding Company Income, foreign base company services, sales and shipping income, income from the insurance and reinsurance of United States' risks and earnings from investment in U.S. property.[79]

The requirement that U.S. shareholders should report their pro rata share of the tainted income of a CFC follows the approach first adopted in the Foreign Personal Holding Company provisions in 1937. However, because the 1962 CFC rules embrace foreign operations engaged in ordinary trading activities, they are significantly more important than the FPHC rules.

Although not a feature of the CFC legislation contained in Sections 951-964 of the Code, there is an important provision, introduced at the same time as the CFC provisions, which deals with the disposition of stock of a CFC. Any gain arising from the sale or exchange of the stock of the CFC is subject to tax as ordinary income to the extent that it is attributable to

profits of the CFC accumulated after 31st December 1962, provided the U.S. shareholder whose stock is sold or exchanged has owned 10% or more of the voting stock of the CFC at any time during a five-year period ending with the date of sale or exchange.[80]

Although the scheme of the legislation may appear relatively straightforward, the host of statutory definitions, qualifications, exceptions and limitations that comprise Subpart F make it one of the most complex areas of U.S. tax law.

The Subpart F legislation was passed because, in spite of the earlier anti-avoidance legislation, U.S. corporations and individuals still found advantages in placing their foreign income generating activities in a foreign corporation under their control. This was because the foreign source income of the foreign corporation was not immediately subject to U.S. tax. As a result, U.S. tax would only be payable when the earnings were directly remitted to the shareholder as dividends or indirectly in the form of a gain on the disposal of the foreign corporation's stock. Subpart F legislation stopped this possibility, but only selectively.

6. Passive Foreign Investment Companies (PFIC)

The reason for the introduction of the latest "tentacle" of the hexapus has been explained recently as follows:

> "Because with careful planning ..... the five tentacles of the pentapus could be successfully avoided, and U.S. persons thus could invest in passive assets through foreign corporations so as to achieve deferral and conversion of ordinary income to capital gain, Congress decided to add the sixth tentacle - the PFIC."[81]

Prior to the enactment of the PFIC provisions, Subpart F and the Foreign Personal Holding Company provisions would require current taxation of certain passive income of U.S. controlled foreign companies. Other provisions prevented U.S. shareholders of CFCs and Foreign Investment Companies from disposing of their stock in such companies and taking out earnings that had escaped current taxation at capital gains tax rates.[82] However, these latter provisions could be avoided if no U.S. person owned 10% or more of the stock of the foreign company or if U.S. shareholders in total owned less than 50% of the shares. This meant that a U.S. person could invest in an offshore fund in these circumstances and avoid U.S. tax on the income of the fund until it was distributed. In addition, if the U.S. taxpayer sold stock in the fund, the transaction would be subject to capital gains tax treatment.

The new PFIC provisions in sections 1291 -1297 of the Code now either currently tax U.S. shareholders in such a fund on the passive earnings of a PFIC or impose an interest charge on U.S. shareholders who defer current taxation, thus removing any tax incentive to invest in foreign offshore funds instead of U.S. domestic funds.

A PFIC is any foreign corporation if 75% or more of its gross income is passive income or if 50% or more of the average annual value of its assets held during the tax year do not produce active income.[83] There are no ownership thresholds similar to the Subpart F rules and thus, once the income or asset test is satisfied, the PFIC rules will apply to any U.S. shareholder regardless of the overall degree of U.S. ownership.

Foreign holding companies that own operating subsidiaries will not generally be caught by the PFIC rules because if they own 25% or more of the stock of an operating company they are treated as owning a proportionate share of that company's assets and income directly.[84]

The PFIC provisions, like the FIC provisions, are concerned chiefly with the portfolio investor and therefore need not be considered in any further detail.

Summary

Before proceeding to the detailed consideration of Subpart F, it is worth recapitulating the broad objectives of the "hexapus" legislation as described in the previous pages.

The earliest measure, the Accumulated Earnings Tax, attacks "unreasonable" accumulations within a corporation. This tax was ill-suited to dealing with incorporated pocket books where the fisc sought to challenge the very existence of a corporation in circumstances where it was interposed between the taxpayer and certain sources of income. Accordingly, the PHC provisions were enacted to combat the use of such corporations. The FPHC provisions were introduced to prevent avoidance of the PHC provisions by the device of using foreign-incorporated companies. The FIC provisions, aimed at portfolio investors, effectively prevent the use of widely-owned overseas corporations being used by U.S. shareholders to achieve tax-free accumulations. The diversified stock holding would, in the absence of the FIC provision, take such companies outside the ambit of either the PHC or FPHC provisions. All the measures so far discussed are directed chiefly at preventing tax avoidance by individuals, i.e. U.S. citizens or resident aliens. This is not the case with regard to the Subpart F provisions.
As has been observed, there occurred in the 1950s something of a shift in emphasis from concern over the tax avoidance of individuals (demonstrated by the concern with closely held corporations) to tax avoidance by corporations. This is evidenced by the passing of the Subpart F provisions in 1962, which, for the first time, target foreign income of overseas subsidiaries of non closely-held U.S. multinational corporations.

It is of course true that the Subpart F provisions do also attack the use of controlled foreign corporations by individuals (as opposed to U.S. corporations) but it is clear from the available material relating to the promulgation of the legislation that the real target was American firms operating through foreign subsidiaries located in tax havens. This material will be considered in the next section, dealing with the background to the Subpart F legislation.

Finally, the most recent addition to what is now a "hexapus", namely the PFIC legislation, is directed chiefly at individuals who were able to avoid the FIC (and other) provisions by carefully choosing investment vehicles where the appropriate U.S. ownership restrictions were not breached. The PFIC provisions represent a fundamental change in the U.S. taxation of foreign corporations because they apply without regard to the level of U.S. control.

BACKGROUND TO THE SUBPART F LEGISLATION

The introduction of the subpart F legislation was heralded in President Kennedy's 1961 tax message.[85] This followed a two-year period of protracted discussions on federal tax reform which had commenced in 1959. In that year the House Ways and Means Committee considered ideas for broad tax reforms based on submissions from practitioners, academics and other interested parties.[86] The overall tenor of these hearings was towards liberalising the tax treatment of foreign income. This would probably have included simplifying the operation of the FPHC rules. However, there was also some suggestion that the FPHC rules should be extended to include other than foreign passive income.

By 1961 thoughts of liberalising the tax treatment of foreign income had all but disappeared. In that year, the Treasury asked Congress to provide detailed rules for the allocation of income and expenses relating to overseas operations of U.S. taxpayers. Further evidence of a new tougher approach was stated by President Kennedy in his important 1961 tax message:-

> "Changing economic conditions at home and abroad, the desire to achieve greater equity in taxation, and the strains which have developed in our balance of payments position in the last few years, compel us to examine critically certain features of our tax system which, in conjunction with the tax system[s] of other countries, consistently favour U.S. private investment abroad compared with investment in our own economy"[87]

Before analysing the detail of the President's tax message it is important to appreciate the primary factors, outlined in the quotation above, that underlie the new approach. Three specific points are identified:

(a) "changing economic conditions at home and abroad"

(b) "the desire to achieve greater equity in taxation"

(c) "the strains which have developed in our balance of payments position in the last few years".

"(a)" is a reference to the relative strength and growth of the European and Japanese post-war economies (in comparison to the U.S.) and "(c)" refers to the U.S. growing balance of payments deficit. Both these points are poor justifications, judged from the perspective of international fiscal law, for extending the taxation of foreign income in the manner achieved by the Subpart F legislation. The second point, "(b)", is an excellent justification for the legislation from the point of view of IFL but only, of course, if the legislation does <u>indeed</u> achieve greater equity in the taxation of such income (a point considered in greater detail in the appraisal of the legislation in the next chapter).

Having stated the rationale underlying the new proposals, the President went on in his message to deal with the specific target, namely "the elimination of tax

deferral privileges in developed countries and "tax haven" deferral privileges in all countries".[88] The perceived problem and its consequences were first set out as follows:-

> "Profits earned abroad by American firms operating through foreign subsidiaries are, under present tax laws, subject to U.S. tax only when they are returned to the parent company in the form of dividends. In some cases, this tax deferral has made possible indefinite postponement of the U.S. tax; and in those countries where income taxes are lower than in the United States, the ability to defer the payments of U.S. tax by retaining income in the subsidiary companies provides a tax advantage for companies operating through overseas subsidiaries that is not available to companies operating solely in the United States".[89]

The President made it clear that his attack on the elimination of tax deferral privileges was part of an aggressive approach to international tax avoidance and tax havens generally:-

> "The undesirability of continuing deferral is underscored where deferral has served as a shelter for tax escape through the unjustifiable use of tax havens such as Switzerland. Recently, more and more enterprises organised abroad by American firms have arranged their corporate structures - aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximise the accumulation of profits in the tax haven - so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad... ".[90]

The President therefore recommended in his tax message legislation which would tax American corporations on the current share of the undistributed profits realised in that year by foreign subsidiary corporations. However his proposals related only to foreign subsidiary corporations located in developed countries, on the ground that:-

> "certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries".[91]

The approach to the use of the "deferral privilege" in developing countries was not quite as straightforward. The President first stated that tax deferral should continue for income from investment in the developing economies, but:-

> "On the other hand, I recommend elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance and others that typically seek out tax haven methods of operation. There is no valid reason to permit their remaining untaxed regardless of the country in which they are located".[92]

A number of the points raised in the President's message were amplified by the Treasury Secretary before the House of Representatives' Ways and Means Committee, particularly the claim made by the President that the legislation would have a neutral effect on genuine business activities:-

> "There is absolutely no thought of penalising private investment abroad which rests upon genuine production or market activities..."[93]

It will be clear from all the preceding quotations that the objectives of the parties introducing the legislation were not simple: the legislation was primarily intended to:- help cure the balance of payments deficit; assist in restoring the position of the U.S. in the light of the thriving economies of Europe and Japan and achieve greater equity in taxation. There was also the desire to contribute to the fight against international tax avoidance and tax havens in general; to withdraw tax deferral in the case of developed countries in so far as it was used in conjunction with tax haven activities and yet to retain, for policy reasons, tax deferral for investment in less developed countries. On top of all that it was also intended not to prejudice or penalise in any way "private investment abroad which rests upon genuine production or market advantages".

The extent to which the legislation achieves its objectives will be considered in the following chapter. For the present, it is reasonable to observe that, based on the degree to which specific tax legislation in general is able empirically to meet a variety of objectives simultaneously, the hope that the Subpart F legislation would achieve the multitude of objectives that have been set out above was possibly somewhat optimistic.

Following the 1961 tax message, testimonies and submissions from a variety of businesses, academics and professional tax advisors were made to the House Ways and Means Committee[94] before the passing of the House of Representatives' Bill 10650. This bill did not go as far as the President had recommended; it merely provided that U.S. shareholders of foreign corporations were to return for tax purposes the undistributed earnings of certain controlled foreign corporations.[95] Commenting on the measures the Treasury Secretary made it clear that the legislation in the form proposed by the House was not adequate. He criticised the fact that the foreign tax deferral issue had not now been treated fully and directly and stated that this inevitably resulted in the retention of a substantial tax advantage for investment abroad in comparison to investment at home:-

> "Tax deferral... serves as a special tax stimulus for American capital to go abroad and to stay abroad. No useful purpose or American interest is served when this artificial diversion is to highly developed countries. The efficient allocation of our own and world resources is upset".[96]

The Senate made a number of significant amendments to the House bill and produced a number of measures which ultimately became Subpart F. The design of the Senate proposals was "to end tax deferral on "tax haven" operations by U.S. controlled corporations".[97]

The Senate measures included the attribution of certain types of undistributed income to the U.S. shareholders of a controlled foreign corporation where 50% or more of the combined voting stock of the corporation was held by U.S. shareholders, each having at least a 10% or greater stock interest. Consequently, the holdings of foreigners or Americans with less than a 10% interest were not taxed by the provisions.

The Senate proposed that two categories of income should be attributed to U.S. shareholders in this way: income derived from the insurance or reinsurance of U.S risks and foreign base company income, which was comprised of base company personal holding company income, base company sales income and base company service income. These two categories of income were collectively "Subpart F income", though the categories of Subpart F income have since been expanded. As well as attributing undistributed Subpart F income to U.S. shareholders, the Senate bill also provided that earnings invested in U.S. property (with certain exceptions) be similarly taxed to U.S. shareholders of the CFC.[98]

Following the Senate amendments the bill was passed without further changes in conference[99] and it became law for taxable years beginning after 31st December 1961.[100]

Before proceeding to consider and evaluate the main issues raised by the U.S. approach to anti-tax haven legislation it will first be necessary to set out the main provisions of the legislation as it now stands. The main principles of the legislation are therefore outlined in the following final part of this chapter.

THE CURRENT SUBPART F PROVISIONS

To attempt anything like a comprehensive description of the legislation would be quite impossible within the confines of a few pages due to the enormous complexity of the statutory provisions. The difficulty is well expressed by one commentator:-

> "In an effort to cover every contingency, the rules of Subpart F reach and never leave a lofty plateau of complexity that the Internal Revenue Code had previously attained only in occasional subsections....".[101]

The recent detailed amendments to Subpart F contained in the Tax Reform Act 1986 have done nothing to simplify the complexities to be negotiated in the statutory provisions. Therefore, the description of the legislation must necessarily be limited to a short consideration of the major features of the provisions of Subpart F. A brief overview of the relevant statutory provisions is contained in Appendix I.

The kernel of the legislation is the "controlled foreign corporation" itself. This is defined in s.957(a) to mean any foreign corporation of which 50% or more of stock in terms of value or voting power is owned by United States shareholders on any day during the taxable year. However, for the purposes only of taking into account income derived from the insurance of risks outside the country of incorporation of the CFC, the meaning of the term "controlled foreign corporation" is revised. The effect is that the legislation applies to corporations of which 25% (rather than 50%) or more of the stock (in value) is owned by U.S.

shareholders on any day during the taxable year if the gross amount of premiums received by the foreign corporation during the taxable year which are attributable to the insurance of U.S. risks exceeds 75% of the gross amount of all premiums received for insuring or reinsuring all risks.[102]

A "U.S. shareholder" is a "U.S. person" owning 10% or more of the CFC's voting stock.[103] In general, overseas subsidiaries which are wholly owned by U.S. corporations will be easily identified as being CFCs by the rules of s. 957 considered above. In other cases where there exists a more complicated pattern of ownership, the detailed rules of s. 958 applying to direct ownership, ownership through foreign entities and constructive ownership will be applied.[104] The general rule is that "stock owned" means stock owned directly or indirectly. Where stock is owned through foreign entities (corporations, partnerships, trusts, estates) such stock is considered as being owned proportionately by its shareholders, partners or beneficiaries as relevant. The effect of this rule is to create a chain of ownership, though attribution under the rules stops with the first U.S. person in the chain of ownership running from the foreign entity (or entities).

There are in fact two distinct sets of attribution rules of stock ownership which are applied for separate purposes:-[105]

(a) To determine whether a U.S. person owns 10% or more of the stock of the CFCs whether owned directly, indirectly or constructively. If so, the U.S. person is taxed by the rules below (even if the actual holding is less than 10%) and the U.S. person's attributed stock is taken into account in determining whether the 50% control test is met.

(b) To determine what part of the CFC's income is taxed to each shareholder identified by the above test. In this case only the stock owned directly and indirectly is considered. Stock owned constructively by the shareholder is not taken into account.

Difficulties will arise in cases where the ownership of the stock is not relatively stable since the complicated determinations as to stock ownership would then be applied not only at the year end but also throughout the year on a day to day basis. This is because a corporation may qualify as a CFC for part of the year only. In such a case, the amount of income attributed to its shareholders (under s. 951) is reduced proportionately. However, there is a de minimis rule in s. 951 (a): if a foreign corporation qualifies as a CFC for less than thirty days during a taxable year, none of its income is apportioned to its shareholders. Where the thirty day period is exceeded the general requirement is that every "U.S. shareholder" of a CFC must report in his gross income his pro rata share of the "tainted" income of the CFC.

In very broad terms, the categories of the tainted income so taxed are those from the insurance of risks outside the country of organisation of the CFC; income from sales, service or shipping subsidiaries; certain types of passive income (dividends, interest and rents); and the sum of bribes paid and income arising from boycott related operations. The various different types of income attributed to U.S. shareholders of CFCs are discussed in more detail in a separate section below.

The amount attributed to the U.S. shareholder by s. 951 is computed to exclude amounts actually distributed by the CFC. Where the Subpart F rules operate to tax undistributed income in the hands of the shareholder, an adjustment under s. 961 is made to the basis of the stock in the CFC held by the U.S. shareholder. The broad effect of s. 961 is to increase the taxpayers basis of stock by the amounts required to be included in his gross income under s. 951 (a) (i.e. as though the amount attributed to him had been reinvested in the stock of the CFC). S. 959 contains rules designed to ensure the U.S. shareholder is not taxed twice and thus subsequent distribution of these previously taxed amounts can be distributed tax-free, although the basis of stock is adjusted down to prevent a double benefit.

An individual stockholder may elect under s. 962 to be taxed at corporate rates on Subpart F income. He is then entitled to the foreign tax credit in accordance with rules similar to those applied to corporations.

ATTRIBUTABLE INCOME

One of the more complicated areas of the Subpart F legislation is that concerning the income attributed to U.S. shareholders of the CFC. This income has already been referred to as including a number of components. These, together with their respective sub-components, are as follows:-

1. Subpart F income:[106]

   (a) Income from the insurance of risks outside the CFC's country of incorporation.

   (b) Foreign base company income:
      (i) Foreign personal holding company income.
      (ii) Foreign base company sales income.
      (iii) Foreign base company services income.
      (iv) Foreign base company shipping income.
      (v) Foreign base company oil related income.

   (c) Income attributable to operations in boycotting countries.

   (d) Illegal payment of bribes, kickbacks, etc.

2. Increase in earnings invested in U.S. property.[107]

   Even where income is prima facie within the Subpart F categories, it does not constitute Subpart F income if it is actually distributed to U.S. shareholders[108] or if it is income which is effectively connected with the

conduct of a U.S. trade or business by the CFC (unless the income is excluded from tax or subject to tax at reduced rates under the terms of a double tax treaty).[109] In both cases, the income would be subject to U.S. tax in any event. The categories of income subject to the Subpart F provisions are explained in more detail below.

1. Subpart F income.

(a) Income from insurance of risks outside the CFC's country of incorporation.[110]

Under s. 953, the net income from insurance or reinsurance of risks outside the CFC's country of incorporation (whether relating to life or property) is computed as if the CFC were a domestic corporation, subject to certain modifications.[111]

(b) Foreign base company income.[112]

Foreign base company income is a component part of "Subpart F income" but is itself comprised of the following categories of income:-[113]

(i) Foreign personal holding company income.
(ii) Foreign base company sales income.
(iii) Foreign base company services income.
(iv) Foreign base company shipping income.
(v) Foreign base company oil related income.

(i) Foreign Personal Holding Company Income (FPHCI).

FPHCI is computed as if the CFC were a FPHC so that the definition of FPHCI is as given in s. 553 of the Code

(discussed earlier in this chapter). However, there are several amendments to the FPHC rules for the purposes only of the CFC rules.[114] For example, rents (unless excluded by the provisions discussed below) are taken into account whether or not they exceed 50% or more of gross income (whereas they are only included in FPHCI by s. 533 if they constitute less than 50% of gross income). Prior to the Tax Reform Act 1986, dividends, interest and gains from the sale or exchange of stocks and securities received from unrelated persons in the active conduct of a banking, financing or similar business, or from an insurance company's investment of unearned premiums, were excluded from FPHCI. This exclusion has now been repealed and the scope of FPHCI for the purposes of Subpart F been considerably expanded by the 1986 Tax Reform Act. Following that Act, other types of income are now also included as FPHCI: gains from the sale of property that give rise to passive income; income from commodities transactions; foreign currency gains; income equivalent to interest; passive leasing income; and income payments from related corporations in the same country that reduce the Subpart F income of the payors (e.g. interest, rents, royalties). Certain income derived from related parties is also excluded from FPHCI, though only in certain restricted cases (e.g. dividend and interest received from a related company which is created or organised, and which has a substantial part of its assets, in the foreign country in which the CFC is located).

(ii) Foreign Base Company Sales Income.

Broadly, such income is defined by s. 954(d) as income from the purchase or sale of property other than realty. In general, this type of income is limited to sales and purchases between related parties where the property is resold to a non-related party without any significant work being carried out on the property by the seller. The provision applies only in the case of property which is manufactured, produced, grown or extracted outside the country in which the CFC is organised.[115] Effectively therefore "foreign base company sales income" is the income of sales subsidiaries.

(iii) Foreign Base Company Services Income.[116]

This type of income is income derived from technical, managerial, industrial, commercial or other skilled services which are performed for any related person outside the country of organisation of the CFC. It does not include income derived in connection with the performance of services which are related to the sale by the CFC of property it manufactures or produces provided the services are performed prior to, or in connection, with its sale.

(iv) Foreign Base Company Shipping Income.[117]

Such income is income attributable to the use of aircraft or ships in foreign commerce or to the performance of services in connection with such use.

(v) Foreign Base Company Oil Related Income.

Foreign base company oil related income follows the definition of foreign oil-related income which is defined elsewhere in the Code.[118]

In all cases (i) to (v) above, the gross amount of each item is reduced by deductions properly allocable to such income.[119] Further, an important exemption provides[120] that foreign base company income and insurance income is not to include any item of income received by a CFC if it is established to the satisfaction of the Treasury that such income was subject to an effective rate of income tax imposed by a foreign country which is greater than 90% of the maximum rate of U.S. corporate tax.[121]

Where this provision does not apply the proportion of gross foreign base company income should be considered. Under a special rule,[122] where the foreign base company income is less than the lower of 5% (prior to 1987, 10%) of gross income or $1 million, it is not to be treated as gross income for the purposes of attribution to U.S. shareholders. Where such income exceeds 70% of gross income, the entire gross income of the taxable year shall be treated as foreign base company income. Where the foreign base company income is between 5% and 70%, only the items comprising that income are taken into account.

(c) Income Attributable to Operations in Boycotting countries.

Under s.952 (a)(3) earnings of a CFC which are attributable to operations in connection with which there was an agreement to participate in or co-operate with an international boycott are Subpart F income. This is a policy measure designed to frustrate the requirements of those countries which demand participation in such boycotts as a condition of doing business with them.

(d) Illegal Payments such as Bribes, Kickbacks, etc.[123]

These payments are payments which would be unlawful under the Foreign Corrupt Practices Act of 1977 if the payor were a U.S. person and which are paid, directly or indirectly, by a CFC in the tax year.

2. Increase in Earnings Invested in U.S. Property.[124]

The reason this type of investment is included in the amounts attributed to U.S. shareholders is that the acquisition by the CFC of U.S. property is generally regarded as having the practical effect of a distribution to its shareholders. There is a wide definition of U.S. property[125] which includes any tangible property acquired after 1962 that is located in the U.S.; intangible property such as patents, inventions, etc which may be used in the U.S.; and stock of a domestic corporation. The Subpart F rules will therefore include as attributable income a variety of methods of effectively repatriating foreign earnings to a U.S. parent; for example, the making of a long term loan by a CFC to its U.S. parent.

Complex rules exist for computing the change in earnings invested in U.S. property and there are also certain exceptions to the definition of U.S. property.[126]

Because other types of Subpart F income are defined by reference to their source and this category relates to an increase in investment in U.S. property, without regard to the source of that investment, the same earnings could be counted twice. However this possibility is specifically prevented by a rule under which "tainted" income is excluded in computing the increase in earnings invested in U.S. property.[127]

Having set out above in outline the major elements of the Subpart F legislation, it is now possible to proceed to an evaluation of the U.S. approach in more general terms, concentrating in particular on the key policy issues from the perspective of IFL. This discussion is contained in the following chapter.

CHAPTER 4 - NOTES

1 International Fiscal Association, Tax Avoidance/Tax Evasion, Cahier de Droit Fiscal International, vol. 68a (Kluwer, 1983). p. 333.

2 Note 1, Ibid.

3 This is the case with the Subpart F provisions in particular where the Regulations are more extensive and detailed than the legislation itself.

4 See generally on this topic, J. Tiley, "Judicial Anti-Avoidance Doctrines: Corporations and Conclusions" [1988] BTR p. 108.

5 69F. 2d 809 (2nd Cir. 1934) affirmed 293 U.S. 465 (1935).

6 See, for example, Bazley v. Commissioner (331 U.S. 737 (1947)).

7 Barnett v. Commissioner 364F. 2d 742 (2nd Cir. 1966) cert. denied, 385 U.S. 1005 (1967).

8 Lucas v. Earl (281 U.S. 111 (1930)).

9 This was certainly the conclusion reached by the International Fiscal Association: see International Fiscal Association seminar paper "Recourse to Tax Havens - use and Advice" (Kluwer, 1980) p. 97: "However, the question whether there is an underlying principle has been specifically put to our American correspondents and both have replied in the negative."

10 The Treasury representatives testified in April 1983 before the House Governmental Operations Committee's subcommittee on Commerce, Consumer and Monetary Affairs; see further: W.P. Streng, "U.S. Taxation of International Business Transactions 1983", Intertax 1984/4 p. 137 at 144.

11 The recent U.S.-Netherlands double tax treaty, signed on 18 December 1992, contains highly detailed anti-treaty shopping measures and, interestingly, makes specific reference to "tax haven" regimes (in Art 24(4)).

12 Art 16 U.S. Model Tax Treaty, see PH Federal Taxes, Tax Treaties I, 1093. The U.S. model treaty has recently been withdrawn, although this has not dampened the enthusiasm of the U.S. authorities for anti-treaty shopping treaty provisions.

13 It should be noted that the term is beginning to be used expressly - see note 11.

14 The point is confirmed by Gordon (see note 16) at pp. 44-45 of his Report. A more recent commentator makes a similar comment in remarking that "'war' was first declared on tax havens in 1961 by President Kennedy. This

led on to the Subpart F legislation..." (see D.W. Williams, Trends in International Taxation, (Amsterdam, 1991).

15 Note 1, Ibid pp.344-5.

16 A Report to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy), submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981.

17 Note 16, Ibid. p.3

18 Note 17, Ibid.

19 Note 16, Ibid. p.43

20 Note 19, Ibid.

21 The historical and policy evidence to support this view is summarised in the Gordon report see note 16 at pp.1-3 (see especially first and second paragraphs on p. 3) and pp.14-58.

22 Note 16, Ibid. p.43

23 Revenue Act of 1921, s.240(d)

24 The most recent relevant development was the issue by the IRS on 13 January 1993 of the "temporary regulations" covering transfers of tangible and intangible regulations.

25 Spaeth, "Section 482 Past and Future", 47 Taxes 45 cited in 45 TLQ 95

26 s.482 was last amended in 1986 by the Tax Reform Act (see s.1231 (e)(1) of Public Law 99-514). Prior to that the section consisted of only one sentence.

27 See note 24 for comment on the latest regulations under s.482.

28 Note 16, Ibid, p 52

29 IRC s.864(c)(4)(B)

30 IRC s.269(a)(2)

31 This follows from the statutory drafting of the provision - see s.269(a)(1), (2).

32 See code sections 332, 351, 354, 356 and 361.

33 H.R. Rep. No. 708, 72d Cong., 1st sess., 20 (1932), 1939-1 C.B. (Part 2) 457, 471

34 See Revenue Act of 1932, s. 112(k); Revenue Act of 1934, s. 112 (i); Revenue Act of 1936 s. 112(i); Revenue Act of 1938 s. 112(i); 1939 IRC s. 112(i)

35 As increased from 27.5% by the Tax Reform Act 1976

36 See s. 1492 (2)(A)

37 s. 1492(3)

38 s. 1492(2)

39 The emphasis on information returns has recently been taken a step further. Under the new "temporary regulations" of s. 482 see note 24), the taxpayer is in effect required to document transfer pricing policies and the rationale for such policies at the outset of any arrangement. See further John Berry, "New IRS Transfer Pricing Regulations" The Tax Journal, 4 February 1993 pp. 6-8.

40 Interestingly, Harvey Dale's perception confirms the view reflected in this and the next chapter that U.S. fiscal policy in general, and Subpart F in particular, represents a "patchwork" or amalgam of various disparate policies which cannot readily be explained as a coherent and rationale framework.

41 Further details on the terminology referred to are to be found in K. Klein, N.H. Kaufman, "Passive Foreign Investment Companies" Tax Management International Volume 16, No. 6, June 12 1987, p. 223.

42 Revenue Act of 1913, s. 11(A)(2).

43 See now IRC ss 531 and 532

44 s. 553(a)

45 Treasury Regulations s. 1.537-2

46 s. 532(b)(1), (2).

47 Regulation s. 1.532-1(c).

48 This is suggested by the observation of Professor Paul McDaniel that some basic questions are still unresolved concerning the computation of tax in the case where a Foreign corporation is subject to the Accumulated Earnings Tax because of the taxable status of its shareholders. For example, it is not clear whether the earnings and profits referred to are limited to earnings and profits from U.S. sources only or include the Foreign corporation's

worldwide earnings and profits. Similarly, with regard to the "reasonable needs of the business", it is not clear whether there needs include the worldwide needs of the Foreign corporation or only its U.K. needs. See country report on the Unites States by Professor P McDaniel in Rotterdam Institute for Fiscal Studies, International Tax Avoidance (Kluwer, 1978) Volume B, p.271.

49 Revenue Act of 1918 s.220.

50 Senate Finance Committee, S. Rep. No 617, 66th Cong. 3rd Sess. 5 (1918).

51 See, for example, H. Rep. No 179, 68th Cong. 1st Sess. 22 (1924). The same concerns can be seen in 1928, when Congressman Garner of Taxes observed: "The advisory committee, in a very delicate way, intimated that the Treasury Department has not enforced the law. I say "delicate" because they call attention to the fact that it is very difficult to administer the law, and the result is that they suggest a remedy" (69th Cong. Rec 519 (1928)).

52 69th Cong. Rec. 520 (1928).

53 H. Rep. No. 1337, 83rd Cong. 2nd Sess. 52 (1954).

54 H. Rep. No. 704, 73rd Cong. 2nd Sess. 12 (1934). See also S. Rep. No. 558, 73rd Cong. 2nd Sess. 15 (1934).

55 Richard Gordon observes: "The Congress, in adopting this provision, acknowledged that the Accumulated Earnings Tax was not working to prevent some significant abuses in the area." See Note 16, Ibid, p.54

56 See s.543

57 ss 542(a)(1) and (2).

58 s.542 (a)(1) and (2)

59 s.544

60 The rate of 50% is imposed by s.541, as amended by the Economic Tax Recovery Act 1981. The rate was 70% before 1982.

61 s.542 (c).

62 s.545 (a).

63 Hearings, Joint Committee on Tax Evasion and Avoidance, p2 (1937).

64 Note 63, Ibid.

65 Statement of Arthur H. Kent (Treasury representative) Hearing, Tax Evasion and Avoidance, House Ways and Means Committee, August 9, 10 1937, pp 70-71.

66 S. Rep. No 1242, 75th Cong., 2nd Sess., 1939-1 C.B. (Part 2) 713.

67 HR. Doc. No 337, 75th Cong., 1st Sess. 1937.

68 s.951(d).

69 Once the foreign corporation has been classified as a FPHC, the percentage requirement drops to 50% for subsequent years, subject to certain qualifications.

70 s.552(a)(1) and s.552(a)(2).

71 s.551(a).

72 s.554.

73 s.555(b). This technique of attributing the income of the subsidiary to the foreign parent corporation is to be contrasted with the so-called "hopscotch" principle used in Subpart F provisions under which the income of the foreign subsidiary is attributed through the chain of foreign ownership directly to the U.S. shareholder. See section 951(a).

74 IRC s.1246(a)(1)

75 It should also be noted that an alternative to the treatment set out in the text was available under s.1247, which allowed a Foreign investment company to elect to have its U.S. shareholder taxed substantially like shareholders in domestic regulated investment companies. This would mean that the U.S. shareholder would be currently taxed on the ordinary income of the company since 90% of the income had to be distributed annually. The election was required to be made before 1963 and was binding on all subsequent years.

76 The title "subpart F" is derived from the location of the provisions in the Code - subpart F, Part III, Subchapter N, Chapter 1.

77 s.957(a)

78 s.951(b)

79 See generally s.952

80 s.1248

81 Note 41, Ibid, Footnote 4.

82 Section 1248 in the case of a CFC and section 1246 in the case of a Foreign Investment Company.

83 s. 1296(a)

84 s. 1296(C)

85 President's 1961 Tax Recommendations, reprinted in 1 House Hearings on the Tax Recommendations of the President, 87th Cong., 1st Sess. 8-10 (1961).

86 House Ways and Means Committee 86th Cong., 1st Sess., 2145 et seq. (11/16/59); Penal discussions on Income Tax Revision, House Ways and Means Committee, 86th Cong. 1st Sess. 1145 et seq., especially p1175 (12/16/59).

87 Note 85, Ibid.

88 Note 85, Ibid.

89 Note 85, Ibid.

90 Note 85, Ibid.

91 Note 85, Ibid.

92 Note 85, Ibid.

93 Note 85, Ibid at pp27-28.

94 3 House Hearings on the Tax Recommendations of the President, etc 87th Cong. 1st Sess. 2587-3553 (1961). Also, see Digest of Testimony Presented and Statements submitted to the Committee on Ways and Means with respect to the President's Tax Recommendations, Staff of the Joint Committee on Internal Revenue Taxation, 12-24 (6/27/61).

95 See e.g. 1 Senate Hearings on HR 10650, 87th Cong., 2nd Sess., 5-7 (4/2/62).

96 1 Senate Hearings on HR 10650 87th Cong. 2nd Sess, pp99-100.

97 S. Rep. No 1881, 87th Cong., 2nd Sess. 78 et seq (1962).

98 Earnings of the CFC invested in U.S. property (other than for the use of the foreign trade or business) are treated first as arising out of subpart F income so that, to the extent subpart F income is taxed to U.S. shareholders, there will not arise a double charge to the U.S. shareholders because of

investments in U.S. property. Similarly, dividends paid by the CFC are treated as being paid first out of earnings invested in U.S. property, then out of subpart F income and only finally out of the profits or reserves of the company, in which latter case only do the dividends represent taxable dividends to the shareholders.

99 H. Conf. Rep. No 2508, 87th Cong., 2nd Sess. (1962).

100 See P.L. 87-834, 76 Stat. 960 (1962) (1 U.S. Code Cong. and Adm. News (1962) p. 1232).

101 B.I. Bittker and J.E. Eustace; Federal Income Taxation of Corporations and shareholders, Warren, Graham and Lemont, pp 17-62.

102 s. 957(b).

103 s. 951(b)

104 In general, the constructive ownership of stock rules of support F follow the attribution rules of s. 318, subject to certain amendments. Broadly, under s. 318 a person is deemed to own stock owned by close relatives. Although the application of this rule may result in the U.S. person holding more than 10%, he is still taxed on his pro rata share of attributable income based on the stock owned by him directly or indirectly through a foreign entity.

105 s. 958

106 Defined in s. 952

107 s. 956

108 Treasury Regulations section 1.959 - 1(b)

109 s. 952(b)

110 s. 953

111 Prior to the Tax Reform Act 1986, only income from the insurance of U.S. risks was caught under S. 953. Further, the 1986 changes also repeal the former 5% de minimis exemption for income from insurance of U.S. risks; S. 953(a) as amended by Tax Reform Act 1986, S. 1221(b)(1), (2), (3)(D).

112 s. 954

113 s. 954(a)(1)-(5)

114 s. 954(c)

115 S.954(d)(1)(A).

116 s.954(e)

117 s.954(f)

118 ss.907(c), 954(g)(1)

119 s.954(b)(5)

120 s.954(b)(4).

121 Under law in force prior to 1987, the test was essentially subjective; income would be excluded if it could be shown that a substantial reduction of U.S. or foreign taxes was not a "significant" purpose in creating, acquiring or using the CFC.

122 s.954(b)(3)

123 s.952(a)(4)

124 s.956

125 s.956(b)(1)

126 s.956(b)(2) and s.956(a)(1) and (2)

127 s.959(a).

CHAPTER 5

SUBPART F - DETAILED CONSIDERATIONS

INTRODUCTION

For present purposes the analysis and evaluation of the Subpart F legislation will be separated into three parts, each considered in a separate section below.

First, the "internal" coherence of the legislation will be considered with analyses of the central concepts applied in the statute.

Second, there will be a consideration of the degree to which the policy objectives set for Subpart F have been achieved by the legislation.

Third, and most important from the perspective of IFL, the approach of the Subpart F legislation will be examined from the general perspective of IFL.

SUBPART F - CENTRAL CONCEPTS

The Nature of a CFC.

There are obviously three elements of a CFC, namely that it is a corporation, which is foreign and in respect of which there exists the requisite degree of control. Each element is crucial as a prerequisite to the operation of Subpart F.[1]

(i) The Nature of a Corporation.

Legally, it will be necessary to determine whether the overseas entity is a joint venture, a foreign branch or agency, a partnership or a corporation. Only in the latter case can the Subpart F rules come into play.[2]

The IRS's rules relating to corporate characterisation appear in Reg. s. 301. 7701-2.[3] It appears that these regulations were initially drafted with the objective of making it difficult to qualify as a domestic corporation for the purpose of limiting the availability of corporate fringe benefits which were

not available to non-corporate entities.[4] However, as the use of domestic tax shelters involving corporations grew, the IRS, without ever changing the regulations themselves, has changed its approach to their interpretation. In effect;-

> "the service has done an in-house about-face and now tends to see corporations where partnerships used to exist"[5]

This somewhat partial approach by the U.S. tax authorities is to be regretted as it both reduces taxpayer confidence in the IRS to administer the law fairly and increases the uncertainty attaching to questions of interpretation of the legislation. This latter problem of uncertainty may be particularly relevant in the case of foreign operations since the legal entities used may not readily conform to recognisable U.S. legal entities, thus making the determination of their status for U.S. purposes all the more problematic. Further, the determination may dictate whether Subpart F has any application.

The difficulties in certain cases of identifying the status of the entity are compounded by the fact that the status is determined neither by local law exclusively nor by U.S. federal tax law exclusively but by an application of the two. Although s. 7701 of the Code and the regulations thereunder provide the facts and standards to be applied to classify the foreign entity, the local law of the foreign jurisdiction must also be applied to determine the relevant legal rights and relationship of the members of the organisation, as well as to determine the interests of the members of the organisation in its assets.[6] Thus, the local law is relevant in establishing whether or not the facts of the U.S. federal tax law have been met. Owing to the fact that the characteristics of corporations, partnerships, etc may overlap, the Regulations provide that an entity has corporate status if it

more nearly approximates to a corporation than to a partnership, trust, etc.[7]

(ii) The Foreign Corporation.

There is no definition as such of a foreign corporation other than the statement in the Regulations that "a foreign corporation is one which is not domestic".[8] A domestic corporation is one that is "created or organised" in the U.S. or under the law of the U.S..[9]

The inclusion of the word "organised" in this criterion for domestic corporations is potentially problematic. If, for example, the articles of association or similar documents were drafted in the U.S. but executed outside the country it is not at all clear whether the corporation would have been "organised" in the U.S. However, in practice such matters rarely cause difficulties.

(iii) Control.

Prior to the Tax Reform Act 1986, the test of control depended solely on voting power. That Act has extended the test to include consideration of the total value of the stock. Whether or not the requisite degree of control now exists in the case of a foreign corporation depends upon the ownership of the aggregate total value of its stock or the total combined voting power of all classes of voting stock. If more than 50% of either is owned by U.S. shareholders on any day during its tax year then it is a CFC.[10] The Regulations give extensive commentaries on these rules.[11]

As has been stated in the last chapter, it is clear from the original President's Tax Message, Committee Reports, etc. that the real target of the 1962 Subpart F legislation was the overseas subsidiary companies of U.S. firms which it was considered were being used at the time for profit

diversion and profit extraction purposes, and thus perceived to be depriving the U.S. Treasury of revenue.[12]

It might be expected, therefore, that the notion of "control" used would clearly follow accounting or statutory provisions which stipulate when the parent-subsidiary relationship exists. This appears to have been the intention of the legislation, though the original casting of the test in terms of voting power is the product of a number of different concepts and cannot be clearly attributed to any one specific source.[13] Presumably, other established criteria of control, such as that relating to Personal Holding Companies (which refers to ownership in terms of value alone [14]) were not considered acceptable for the purposes of Subpart F. Perhaps, given the emphasis on attacking corporations where a situation of de facto control exists, the then current FPHC test was felt to be inadequate given the ability of a minority (in terms of ownership of value of stock) to exercise actual management and control of the overseas entity. However, the recent amendment to the test of "control" to include ownership in terms of value alone[15] indicates a partial failure of the original "voting power" test.

The requirement that more than 50% of stock in terms of value or voting power is to be held before an overseas entity can qualify as a CFC follows a widely applied percentage criterion used for accounting purposes. In the United States, for example, the test of control applied for the purposes of preparing consolidated financial statements turns on whether the parent has direct or indirect control of over 50% of the voting power in the subsidiary.[16] Similarly, in the United Kingdom, where a company holds more than half of the nominal value of the equity share capital of another or controls the composition of its Board of Directors, a parent-subsidiary relationship is deemed to exist.[17] Since a subsidiary is, in essence, a controlled company, this would indicate that the approach adopted by

Subpart F conforms with accepted measures of identifying whether or not a situation of "control" exists.[18]

There is no doubt that this was the intention behind the legislation:-

> "what we are talking about here as we specifically define them is American controlled subsidiaries, so we are talking about the ones where the control, a majority of the stock is held by ..... American stockholders, individuals or corporations. That is the definition"[19]

The principle is underlined in the case of Garlock Inc v. C.I.R.:

> "The basic purpose of the 50% test in section 957 (a) was clearly designed and intended to exclude from the definition of a "controlled foreign corporation" only those foreign corporations which were not subject to the dominion and control of U.S. shareholders".[20]

The concept of control is also used in defining a related person. (Whether CFC income is foreign base company income may depend on whether it is received from a related person.) Under new provisions introduced by the Tax Reform Act 1986, the question whether a person is a "related person" turns on whether that person controls or is controlled by the CFC.[21] "Control" is established by the existence of a holding of 50% or more in value or voting power of the relevant stock.

Against this background, the special rule for insurance income, whereby only a 25% rather than a 50% ownership of stock is required before Subpart F can apply,[22] seems incongruous. There is nothing in either the

legislation or the Regulations which accompany it to justify this discrimination in the case of insurance income.

The reason for the introduction of this particular provision (which until the Tax Reform Act 1986 attacked only the insurance of U.S. risks but which now attacks the insurance of all risks other than those in the CFC's country of organisation[23]) was that:

> "Since the passage of the Life Insurance Company Income Tax Act of 1959, which for the first time imposed a tax on underwriting gains of these companies, it is understood that a number of companies involved have attempted to avoid tax on the gains by reinsuring their policies abroad. ....To meet this problem the bill provides that where a controlled foreign corporation receives premiums or other consideration for reinsurance or the issuing of insurance or annuity contracts on property in, or residents of, the United States the income attributable to this is to be taxed to the U.S. shareholders as a part of Subpart F income"[24]

At the time of the introduction of the provision, it would not apply unless the CFC received U.S. note premiums or annuities in excess of 5% of gross premiums. This de minimis provision was repealed by the Tax Reform Act 1986. In justifying the alternative rule of a 25% as opposed to a 50% holding, it was explained:

> "This alternative rule for control is designed to cover cases where the principal business is the U.S. risks but the control is decreased in order to avoid the application of this provision"[25]

However, if it is the case that a foreign company has genuinely been "decontrolled" so that less than 50% is controlled by U.S. persons it is difficult to see, on the conceptual approach of Subpart F, what justification remains for the 50% threshold being reduced to 25% in this one case only.[26] The fundamental approach of the legislation is to attack controlled overseas corporations. Whether a corporation is or is not controlled by U.S. persons depends in general on their influence over that corporation and this in turn is best measured by the amount of stock they hold, whether in value or voting power. However, the alternative treatment accorded to insurance income (the 25% threshold) would seem to imply that the type of income has some bearing on the issue of control of a corporation. Even if this proposition were true, (and no evidence is adduced in favour of it), it would still remain to be demonstrated why insurance income alone had an influence on the "control" of a CFC and thus justified the lower 25% threshold for the purposes of s.957.

U.S. Shareholders.

A foreign corporation will be a CFC if more than 50% of the voting power or value of stock is owned by "United States shareholders", a class defined in s.951 (b) as "United States persons".[27]

The term "U.S. person" is assigned a meaning by s.7701(a)(30) for the purposes of the whole Code[28] and includes:-[29]

(a) A citizen or resident of the United States.
(b) A domestic partnership.
(c) A domestic corporation.
(d) Any estate or trust (other than a foreign estate or trust).

The term is further specifically defined in s. 957 with respect to corporations organised under the laws of Puerto Rico, the Virgin Islands or any other U.S. possession.

The 1937 FPHC rules are directed at "U.S. shareholders" without mention of "U.S. persons". A "U.S. shareholder" was formerly defined[30] in the terms of s. 7701 (a) (which now defines "U.S. persons") without any mention of a U.S. person[31] but this definition was later amended in 1962 to include the term "U.S. person". At the time of the amendment, the House said the term had the same substantive meaning as the then current term "U.S. shareholder".[32] Quite why the "U.S. person" concept should be introduced and defined in terms of an apparently adequate existing notion ("U.S. shareholder") is somewhat mysterious. At best, the meaning of the term is circular and a needless complication.

To qualify as a "U.S. shareholder" for the purposes of Subpart F, it is necessary not only to be a "U.S. person" but also to own (or be deemed to own) 10% or more of the total combined voting stock or value of stock.[33]

The most fundamental characteristic of a CFC is the fact that it is controlled by U.S. shareholders. Whether or not the requisite degree of control exists depends on the ownership of voting power and value of the shares. There is therefore a very close link between the tests of "control" discussed above and the stock ownership rules.[34]

It has been observed that the real target of Subpart F was (and is) overseas subsidiaries of U.S. companies.[35] In most cases, the U.S. parent will hold 100% of the stock of its subsidiary and there will be no doubts that the requisite amount of stock is held and that the subsidiary is, in consequence, "controlled" as defined. In other cases, for example a more widely held foreign corporation, the situation is not so straightforward and the highly complex stock ownership provisions will need to be applied.[36]

However, the notion of control underlies not only the 50% ownership test, but also the 10% test which is applied in determining whether a stockholder is to count as a U.S. shareholder. Whereas the 50% test is broadly reasonable having regard to recognised notions of what constitutes control, the reasoning behind the application of the control concept to the 10% threshold is rather more questionable. In the House Hearings on the original legislation, Secretary Dillon explained how the concept of shareholder control had been applied to produce a requirement of 10% ownership for U.S. shareholders:-

> "We thought 10 per cent [the draft proposal] was reasonable considering the form which new foreign investments have been taking..... I do not think any American company or individual would make an investment that large in a foreign company or in, for that matter, a domestic company unless he had a voice in the management and had some say in what was going to happen. And I would think that with that voice he could make the necessary arrangements to be sure that an adequate amount of dividends would be returned to him at home or else he would not make the investment on that basis".[37]

The 10% threshold is therefore designed to reflect the control that a 10% shareholder is assumed to have. Whether a 10% shareholder has anything like the "voice in the management" he is assumed to have is open to doubt. In terms of recognised accounting concepts a 10% holding in the stock of a company would not generally constitute anything more than a mere investment. In the U.K. for example, equity accounting (accounting applied to "associated" but non-subsidiary companies) is permitted only if the interest of a company in another company is something more than a mere investment. Broadly, the requirement is that the interest is effectively that of a partner in a joint venture or consortium and the investing company can exercise significant influence over the company or, alternatively, the investing company has a long term substantial interest and can exercise significant influence over the company. In both cases, a presumption is

raised that significant influence exists if 20% or more of the equity voting rights of the company are held by the investing company. Where the holding of such rights is less than 20%, significant influence is presumed not to exist.[38]

In setting the minimum stock ownership requirement at 10%, the legislation is in effect recognising that some minimum level of stock must be held before any control or influence over the corporation can be exercised. This is no doubt true in practice. However, setting the threshold at 10% is somewhat harsh. Only in relatively restricted circumstances (for example, a consortium with ten members each with an equal holding in the consortium company) is the 10% figure, or something slightly above it, likely to give the shareholder the "voice in the management" that is an assumption of the legislation. The arbitrariness of the figure is underlined by the fact that if there are 11 U.S. shareholders amongst whom ownership of a foreign corporation is equally divided, CFC status will be entirely avoided. Thus, whilst these U.S. shareholders could each hold 9.1% with impunity, Subpart F would apply in full if the number of shareholders were reduced to ten, each with a 10% holding.[39]

On the other hand, it may be argued that the 10% threshold is reasonable because this is the level at which an indirect credit is available under the U.S. tax legislation. The U.S. indirect credit applies in respect of the overseas tax borne by a non-U.S. company and, broadly, the credit is available to the extent the profits of that overseas company are used to fund a dividend back to the U.S. shareholder.[40] Such an argument was in fact put forward by the Inland Revenue in justifying a similar 10% threshold under U.K. CFC rules.[41] However, it is considered that this argument is misconceived. The "U.S. shareholder" test for Subpart F purposes seeks to identify shareholders who are to be taken as controlling the overseas company concerned. The indirect tax credit test, on the other hand, is designed to identify in what situations a shareholder may be taken to be a non-portfolio investor and thus entitled to a tax credit in respect of dividends received. It is not designed to identify shareholders controlling the overseas company concerned.

It is of course true that the setting of any threshold or minimum requirement will always produce marginal examples, such as the one given above, which suggest a certain arbitrariness in the legislative requirement. However, what makes the 10% requirement rather more suspect is the fact that it is, in a practical sense, set at such a low level. The result is that the legislation is more likely to have the effect not of bringing into charge U.S. shareholders who really can exercise any degree of control but rather to provide a major disincentive to potential minority investors in overseas corporations.

A further problem with the minimum 10% requirement is that it can operate in favour of U.S. partnerships, simply by virtue of the difference in legal status between a partnership and a corporation. Whereas Subpart F will apply to a wholly owned tax haven subsidiary of a U.S. corporation, the same may not be true in the case of a U.S. partnership, such as a large U.S. stockbroking partnership. It would be relatively easy to create a directly owned foreign subsidiary with all the U.S. partners each taking a small percentage of the stock of the tax haven company. This difference would be attributable solely to the fact that a corporation is regarded as a single, separate legal entity, distinct from its shareholders, whereas a partnership is not. If the existence of Subpart F is acceptable in terms of IFL, there seems no good reason why it should not apply uniformly to foreign corporations whether owned by U.S. partnerships or owned by U.S. parent corporations.

Attributable Income Under Subpart F

The variety of types of income which may be attributed to the U.S. shareholders of a CFC raises a number of questions. Most obviously, the different character of the income invites comment. Whereas foreign base company income in all its forms is determined solely by reference to the source of the earnings (very broadly, transactions with related parties), this characteristic is totally irrelevant in the case of another element of attributable income, namely "increase in earnings invested in U.S. property". In the latter case, the increase in earnings in

U.S. property is attributed pro rata to the U.S. shareholders on the totally separate theory that earnings of the CFC have been effectively repatriated to the U.S., despite the lack of any formal dividend payment.[42] There is a link between this theory of "effective repatriation" and the anti-deferral concept underlying Subpart F in general. In both cases, a charge to tax arises under the provisions of Subpart F where it would otherwise not do so: in the case of "effective repatriation" it would, but for s. 956, be possible for a corporation to avoid U.S. taxation on its income but still make that income available to its U.S. shareholders. However the two concepts are certainly distinct. Whereas the other provisions of Subpart F deal with categories of tainted income in respect of which deferral is denied, the "effective repatriation" concept is not aimed at such tainted income at all. This is because the source of the earnings that result in an increase in investment in U.S. property is irrelevant. Moreover, such earnings are specifically directed not to include the CFC's Subpart F income to ensure that such income is not taxed twice.[43]

Therefore, whereas Subpart F income in general consists of categories of income in respect of which the 'deferral privilege' is specifically removed, the 'effective repatriation' provision is a broader anti-avoidance doctrine to prevent a CFC making available its income to its U.S. shareholders without paying U.S. taxation. In fact, the rules in s. 956 are basically an enactment of the 'constructive dividend' doctrine which is itself part of the wider, substance-over-form concept.[44]

The scope of Subpart F income was expanded by the Tax Reform Act of 1976 and two new categories of attributable income were introduced. The theoretical bases of these two new categories are again quite different from those discussed above. First, there is the category of CFC earnings from participation in or co-operation with an international boycott which is to be taxed on the U.S. shareholders of the CFC. Although this is a 'source based' category of income it has little in common with the earlier Subpart F income (which concentrates on reaching related party transactions) and it is based on a quite separate tax policy. Second, certain payments are deemed to be income for the purposes of Subpart

F. Section 952 (a) (4) includes as Subpart F income the aggregate amount of illegal bribes, kickbacks and other payments of a similar character that are paid by the CFC to any foreign government official or agency.

The fact that the scope of attributable income has been expanded by these two different categories of 'income' evidences that broader policy decisions (on the desirability of boycotts and illegal payments, the latter being identified by U.S. criteria) have been implemented via the Subpart F legislation.

The difference in bases by which the various types of income are identified might be more readily explicable if there was nonetheless a common link between the variety of forms of income specified to be within the operation of Subpart F. However, this is manifestly not so as the legislation is drafted to hit a number of quite different targets. First, and perhaps foremost, related party transactions are caught by the provisions. Then there are a series of other provisions which reach certain types of income: the insurance of risks outside the country of incorporation or organisation of the CFC; and income from boycott operations. Finally, there are the types of 'income' which are basically outgoings or payments: the increase in earnings invested in U.S. property, which is based on a broad anti-avoidance doctrine, and the illegal payment of bribes, kickbacks, etc which is a specific policy measure.

It is not clear how these different forms of income fit into a coherent statutory scheme and this leads to the impression that Subpart F has become something of a rag bag of different provisions each with varying objectives and different targets. (It is difficult to justify the inclusion of boycott income and, especially, payments of bribes and kickbacks on almost any explanation of what the Subpart F provisions are supposed to be achieving.) This impression is in no way countered by recent provisions, contained in the Tax Reform Act 1986, which extend the definition of FPHCI to include such items as commodities transactions, foreign currency gains and income equivalent to interest.

The fact that the legislation may have become stratified in this way is not per se a matter to be necessarily criticised. However, there are certain consequences which arise as a result of this stratification which cannot be welcomed.

The sheer complexity of the legislation[45] brings with it a number of problems: the difficulty of administration; comprehensibility; taxpayer hostility; the problem of compliance for any taxpayers not advised by experienced specialists in international taxation; and the inevitable high cost in terms of professional fees of ensuring continuing compliance. These difficulties would certainly be reduced by a separate set of provisions to deal with distinct perceived abuses.[46]

More importantly, the stratification of Subpart F may have a bearing on its acceptability from the standpoint of IFL. This is discussed later in this chapter.

THE OBJECTIVES OF SUBPART F

It was demonstrated in the last chapter that the objectives which the Subpart F legislation was designed to achieve were various and wide-ranging. Other objectives have been added during the twenty-five year life of the legislation, in which time the legislation has been continually amended.

The inclusion of the new categories of Subpart F income added by the Tax Reform Act of 1976 (boycott income and illegal payments) was clearly a policy decision to deter illegal payments and participation in boycotts. Stringent reporting requirements were also imposed in respect of these two income categories. Subpart F nearly became the vehicle for other policy matters in 1977. In April of that year President Nixon introduced a highly protectionist Trade Reform Bill and simultaneously the Treasury released recommendations for corporate tax reform. These recommendations would have expanded significantly the scope of Subpart F so that, for example, income from manufacturing and processing abroad and benefits from local tax holidays would all be subject to U.S. tax.[47] The Treasury recommendations were finally shelved, (partly due to the Watergate crisis) but

they illustrate the degree to which legislation such as Subpart F is regarded as being freely available for implementing other policy objectives.

At the time of the 1976 amendments, it is possible to identify the following broad historical objectives of the legislation, which was intended to:

(i) help cure the balance of payments deficit
(ii) assist the economic position of the U.S.A.
(iii) achieve greater equity in taxation
(iv) contribute to the fight against international tax avoidance and tax havens in general
(v) withdraw tax deferral in the case of developed countries
(vi) permit tax deferral in less developed countries for policy reasons
(vii) avoid prejudicing or penalising in any way genuine foreign investment
(viii) provide fiscal disincentives to foreign controlled corporations making illegal payments
(ix) prevent, or assist in the prevention of, boycotts.

However, notwithstanding all the above points, in 1984 the Joint Committee of Finance stated quite unequivocally that:

> 'The purpose of Subpart F of the Code is to enforce capital export neutrality by preventing the shifting of earnings to a jurisdiction having no natural business nexus with the income and where the income will not be taxed. Otherwise, there would be an incentive to shift earnings into tax havens and away from the United States'.[48]

On the basis of the above statement, it appears that the grounds for opposition to tax deferral have shifted in some measure from those emphasised in 1962. Comments made and objectives set on the introduction of the legislation were primarily concerned with preventing tax avoidance whereas the more recent

concern appears to be with capital export neutrality. The result of these shifts of policy underlying Subpart F is that the task of evaluating the success of the legislation is made considerably more difficult. This applies both to the Subpart F legislation in isolation and to Subpart F in the context of wider U.S. fiscal policy.

The 'patchwork' nature of the U.S. tax legislation discussed earlier has already been noted;[49] what is evident from the above discussion is that Subpart F, itself, is in microcosm a 'patchwork' product of various policies and objectives.

These shifts in policy and emphasis underlying Subpart F have important consequences for the appraisal of Subpart F from the point of view of IFL. These are considered in the next section.

Notwithstanding the above comments, it is arguable that one common strand running through the official view of the objective of Subpart F can be identified. This is the notion that Subpart F is an attack on unjustified tax deferral. With regard to the effectiveness of Subpart F in preventing tax deferral, Marshall Langer was able to report in 1980 that:

> 'It is generally accepted that these rules [the pentapus], especially the Subpart F rules, have been effective in deterring Americans from using tax havens'.[50]

However, although tax deferral has been selectively prevented by the legislation it is nonetheless true that, as will be seen, this has been achieved at a cost from the perspective of IFL.

Even from the point of view of the IRS, the legislative rules have not been a complete success. Since the basic objective of Subpart F was (and remains) to prevent the use of corporations in tax haven countries to divert or extract profits

and thereby achieve tax deferral, it must therefore be somewhat surprising to find that the detailed rules can be used to the taxpayer's advantage in certain cases.

This may be illustrated in the case of s.956, with regard to investment in U.S. property by way of loan. For example, where a U.K. subsidiary of a U.S. parent is subject to a low effective tax rate and does not want to attract advance corporation tax[51] on making a distribution from the U.K., the simple method to repatriate funds to the U.S. would be to lend the available profits to the U.S. parent and ensure that the Subpart F rules apply to deem the loan to be foreign source income of the U.S. parent. A foreign tax credit for the taxes associated with that income would therefore arise. The end result is not only that there has been a repatriation of profits without a U.K. tax cost (by way of advance corporation tax) but that a foreign tax credit is attained. In the absence of Subpart F legislation it would be possible to repatriate the profits without a U.K. tax cost but no foreign tax credit would be obtained. The foreign tax credit derives entirely from Subpart F.

This is not the only way the Subpart F rules can be used to advantage.[52] The fact that the legislation can be used in this way undermines its effectiveness as anti-avoidance legislation and suggests that highly complicated provisions will often provide unintended effects or opportunities to the taxpayer which may run counter to the intended objective of the legislation in question.[53]

The best recent example of this phenomenon arises in connection with the very broad new Passive Foreign Investment Company rules which were discussed in the last chapter:

> 'In enacting the PFIC provisions, Congress may have gone beyond its purpose. The statute seems to result in some unintended tax consequences..... In particular, the PFIC provisions may have the unintended indirect effect of ending tax deferral for non-Subpart F earnings (e.g. trading, service or manufacturing profits) of many

highly profitable controlled foreign corporations, something which both the Kennedy and Carter Administrations unsuccessfully attempted to do directly.'[54]

Because of the unusual complexity of the CFC rules and the PFIC rules, and because there are no statutory provisions co-ordinating the PFIC interest charge rules and Subpart F, a foreign corporation subject to the operation of Subpart F may also be subject to the PFIC rules with a number of apparently unintended[55] and highly complex results.[56]

It makes a nonsense of U.S. fiscal policy in this area if unintended complications are able to achieve by accident what could not be achieved by the policies of two governments. Moreover, if such changes have been effected virtually by accident the whole process of discussion and debate surrounding the enactment of U.S. tax legislation is seriously undermined. For these reasons, the above example is a particularly striking instance of the undesirability of over-complicated legislation. The subject of the complexity of the U.S. and U.K CFC legislation is taken up later in this thesis.

SUBPART F AND IFL

In appraising Subpart F from the perspective of IFL it is of course the criteria of IFL (considered in Chapter One) which must be applied. The existence of Subpart F raises certain general fundamental questions such as the deferral 'privilege' itself, the approach to tax haven corporations, etc. However, these questions are common to all types of CFC legislation and will be considered after discussion of the U.K. provisions. For the present, the consideration of Subpart F and IFL will be restricted to those aspects of IFL which have a bearing on certain specific provisions and the particular approach adopted by the U.S. in enacting Subpart F.

Subpart F will be considered in relation to the two key policies of IFL, equity and neutrality, before certain other general matters relating to IFL are raised.

SUBPART F AND EQUITY

The Categories of Tainted Income

In broad terms, Subpart F income includes passive income of the CFC and other income from specified activities. The official view appears to be that the specified activities caught by Subpart F are those in respect of which income is likely to be shifted offshore in order to deliberately avoid U.S. taxation. However, this interpretation is hardly borne out by the legislation itself. The insurance income derived by a CFC illustrates the point. Until recently, all income from the insurance of U.S. risks and foreign risks of related parties, where the risks were located outside the country in which the CFC was organised, was Subpart F income. Given the apparent desire on the part of the U.S. fisc to counter categories of income which can be shifted offshore, the inclusion of these types of income as Subpart F income is understandable. Consistent with this approach, the CFC could insure foreign risks of unrelated parties without generating Subpart F income. However, significant changes in this area have now been made by the Tax Reform Act 1986 which, as has been noted, provides that income from the insurance of <u>any</u> risk located outside the country in which the CFC is organised is Subpart F income. Thus, where income is derived by a CFC from the insurance of foreign risks (located outside the country of organisation of the CFC) of unrelated persons, such income is now caught as Subpart F income. At the same time the 5% de minimis rule that prevented Subpart F inclusion of insurance income which was less than 5% of the CFCs gross income has been repealed. The combined effect of these changes is that, for practical purposes, virtually all insurance income of a CFC is currently taxable under Subpart F.

In the case of insurance income therefore, there is now no distinction to be made between tainted and non-tainted income. There is, in effect, a legislative

assumption that if a CFC is carrying on an offshore insurance business then it is appropriate for Subpart F to apply.[57]

In the case of other categories of income, Subpart F seems to have an entirely arbitrary application. For example, in the case of a CFC which carries on banking and similar activities, any interest income received in the conduct of its business, whether from related or unrelated parties, will be taxed currently in the U.S. under Subpart F following changes made in the Tax Reform Act 1986.[58] However, the CFC would still be able to earn amounts of income from other traditional banking activities which are not subject to the operation of Subpart F.[59] For example, fees for merger and acquisition advice, advisory fees and profits from issuing Eurobonds should all not be subject to Subpart F. In the case of a bank, interest income and other categories of income derive from similar trading activities. It is not clear why Subpart F is so discriminatory in its application such that some income from activities or transactions with third parties will be caught and other types of similar income will not.[60]

The justification for the extension of Subpart F to include income which has nothing to do with the U.S. and which is not derived from transactions between related parties is not clear. Given the lack of any apparent justification for the extension of Subpart F in this way, it is difficult to draw any other conclusion than that such an extension is inequitable.

However, this extension is also of significance for three other reasons. First, there is the impact on the ability of the CFC to compete with foreign corporations in non-U.S. markets. Second, the extension of Subpart F calls into question the conceptual basis on which Subpart F is founded. Third, the extension of Subpart F discussed above has significant non-neutral effects on general commercial operations. All three matters are discussed in later sections below.

Losses

The first point to note with respect to losses ('deficits') is that there is no provision for their attribution to the U.S. shareholders of a CFC to mirror the current attribution to such shareholders of the profits of the CFC. From the perspective of equity, this imbalance is to be objected to since it leads to an asymmetry which will always favour the fisc.

The Subpart F treatment of losses has changed significantly following the Tax Reform Act 1986. Under law in force prior to that Act the amount of Subpart F income of a CFC to be currently taxed in the hands of U.S. shareholders could not exceed the CFCs earnings and profits as reduced by losses brought forward from prior years. The losses in any other associated foreign corporation above or below the CFC in a chain of companies could also reduce the CFCs earnings and profits (this is the so-called 'chain-deficit' rule).[61]

The 1986 Act, however, repealed the chain deficit rule and introduced a number of other significant limitations on the use that may be made of losses in the CFC.[62] The Tax Reform Act retained the earlier rule that current losses in earnings and profits in any income category, including non-Subpart F income categories, may be offset against Subpart F income for that year. The Act also retained the rule that Subpart F income cannot exceed the CFCs earnings and profits of the year as reduced by losses brought forward, but this rule is substantially modified so that accumulated losses relating to tax years beginning before 1987 may not be carried forward to reduce Subpart F income.[63]

There are further restrictions on losses from periods of account beginning on or after 1987. Such losses can be carried forward without limit if they arise out of activities that give rise to certain narrow categories of income such as foreign-base company oil-related income.[64] However, in these cases the losses in respect of each category can be offset only against the future income of those respective categories.

Not only is there this new requirement for the 'streaming' of losses but there are also conditions to be met in each case before losses can be utilised. For example, Subpart F insurance income can be reduced by losses under the new rule only if the CFC receiving the income was predominantly engaged in the active conduct of an insurance business (as defined[65]) in both the year in which the income was earned and the year in which the loss arose.[66] Similarly, FPHC income can be reduced by losses under the new rule only if the CFC in receipt of the income was predominantly engaged in the active conduct of a banking, financing or similar business as defined[67] in both the year in which the loss arose and the year in which the income was earned.[68]

There are also provisions to prevent the use of losses from other companies: pre-merger losses of a CFC that is merged into a CFC may not reduce post-merger Subpart F income unless the shareholders of the CFC were also shareholders in the merged CFC.[69]

Certain other categories of Subpart F income may not be reduced by accumulated losses at all. Thus, for example, a loss arising in one year from Subpart F sales activities may not be carried forward to offset Subpart F sales income in the next year. This means that in the absence of any Subpart F income in the year in which such losses arose, the losses would go unrelieved. In consequence of the other changes discussed above, losses from non-Subpart F activities of the CFC can never be carried forward to offset Subpart F income in a later year. The general effect of these changes is to further restrict the use that can be made of losses in offsetting currently taxable Subpart F income.

In consequence, the asymmetry between the treatment of profits and losses of the CFC, to which reference was made above, has markedly increased. Several reasons are given in the 1986 Conference Report to support the new restrictions on the use of losses to reduce Subpart F income.[70] One important theme running through the discussion in the Report appears to be the view that without these new restrictions 'too much tax haven income' could be sheltered by U.S. tax

payers through the use of losses.[71] The criteria by which sheltered tax haven income is judged to be 'too much' are neither stated nor explored. However, it appears that a chief factor in this judgement was the ability of CFCs in the pre-Tax Reform Act period to set off losses from non Subpart F income categories against other Subpart F income.[72] For example, in discussing the chain deficit rule the Conference Report states that:-

> 'This rule is inconsistent with the "hopscotch rule", which requires that Subpart F income of a controlled foreign corporation be included currently in the gross income of the corporation's ultimate U.S. shareholders without regard to the income of any intermediate foreign corporation interposed between those owners and the controlled foreign corporation.'[73]

The consideration by the Committee of the use of losses by CFCs takes place almost wholly in the context of preventing avoidance of the Subpart F provisions: there is nowhere in the discussion any significant consideration of the proposals from the point of view of equity and there is absolutely no mention of the relationship (or asymmetry) between the treatment of profits and the treatment of losses. This leads to the conclusion that the very significant restrictions affecting losses brought in by the 1986 Act are motivated primarily by an intention to prevent tax avoidance. This intention is translated into a set of legislative restrictions on the use of losses which are relatively heavy handed. It would appear that consideration of the changes from the perspective of equity has largely been ignored.

'Genuine Production or Market Activities'

In 1961, a significant emphasis was given over to the neutral effect of the legislation on genuine commercial activities and it was stated that 'there is absolutely no thought of penalising private investment abroad which rests upon genuine production or market activities'.[74] As has been noted, a test was

incorporated into the legislation to grant exemption for income where it could be demonstrated that the CFC is not used for the purposes of tax avoidance. The test was subjective and turned on the question whether the CFC was 'formed or availed of' to reduce its U.S. tax liability. This has now been changed to an objective test by the Tax Reform Act of 1986.[75] Under that Act a CFC is not treated as having foreign-base company income or insurance income subject to Subpart F if its income is taxed at 90% or more of the maximum U.S. tax liability on such income. Based on the top rate of U.S. corporation tax of 34% (effective from 1st July 1987), this means that a CFCs income must be subject to a tax of at least 30.6% (34% x 90%) to avoid being Subpart F income.

There are a number of comments to be made. First, the scope of the test is not sufficiently comprehensive. The test applies to insurance income and foreign-base company income but the exception does not apply to foreign-base company oil-related income. Presumably,[76] this is due to the very large amounts of income that are associated with oil related activities. Such large amounts of income might make it worthwhile to use a CFC which is subject to a rate of tax of 90% of the U.S. rate in order to avoid U.S. tax on the remaining 10%. However, if this is the reason oil related income is excluded, it seems illogical that the exemption is withdrawn purely because of the amounts of income involved. Whether or not genuine commercial activity is being carried on is generally not indicated by reference to the monetary size of the relevant transactions or arrangements. If very large amounts of income are involved this may indicate that 'non genuine' motivations to avoid tax may be in point. However, it does not of itself indicate the motivation behind business transactions or arrangements. In short, the fact that the exemption does not include oil-related income is an inequity of the legislation.

The percentage rate of tax which must be achieved (90% of U.S. tax) is also somewhat high. For example, where a U.S. CFC is established and becomes resident in the U.K. and has profits of less than £100,000[77] such that the lower

rate of U.K. corporation tax of 25% applies, it will not be possible to claim the protection of the exemption.

The example illustrates the major difficulty with the exemption. This is that the percentage amount of tax suffered is an extremely unsatisfactory indicator of whether or not 'genuine' business activities have been carried on. Merely by setting the requirement at the 90% rate, the rules necessarily preclude the possibility of carrying on 'genuine' activities for the purpose of the Subpart F rules in a considerable number of jurisdictions, where the tax rate is less than 30.6%. As such, the test, which is supposed to guarantee that investment abroad which rests upon "genuine production" or "market activities" is not to be penalised by the Subpart F rules, cannot be considered a success.

The 90% test does not make any allowances for differences in computing taxable income between the U.S. and foreign countries. A recent private letter ruling illustrates the point. A foreign subsidiary of a U.S. parent was subject to tax at 52% but offset brought-forward losses against its income. The losses arose partly due to business expenses which would have been required to be capitalised under U.S. tax principles. The IRS ruled that the exemption could not apply and the company's income therefore fell to be included in the income of the shareholder.[78]

The fact that Subpart F operates in respect of "genuine" business activities in jurisdictions with an effective tax rate of less than 30.6% is itself a disincentive to U.S. CFCs to compete in such markets. The effect of Subpart F on the competitiveness of U.S. CFCs in foreign markets is considered later in this chapter.

Delegation to Treasury Regulations and IRS

In spite of the immense detail of the legislation, a number of tasks are turned over to the Treasury to discharge by regulations. This, in effect, gives the IRS an

important discretion not merely in applying the legislation but also in implementing certain delegated functions.

The significance of the regulations was demonstrated during the Conference Agreement stage of the Tax Reform Act of 1986. The House Bill suggested an amendment which would have decreased the ownership requirement for CFCs from more than 50% to 50% or more. However, in Conference Agreement the amendment was not included partly due to:-

> "The conferees understanding that, under an existing Treasury regulation, the IRS can, in specified circumstances, deem foreign corporations effectively controlled by 10% U.S. shareholders to meet the more than 50% ownership test even though that requirement would otherwise not technically be met".[79]

The high profile of the Treasury Regulations and the discretionary tasks delegated to the IRS have become largely accepted in the U.S. Certainly, the publication of regulations and rulings which assist the interpretation and understanding of the primary legislation contained in the Internal Revenue Code is to be welcomed. However, where important rules are not contained in the Code but are delegated to be discharged by the IRS or by Treasury Regulations then the situation is less welcome since in such a case the primacy of the legislation is undermined.

SUBPART F AND NEUTRALITY

The Relevance of Neutrality

Throughout the deliberations on and history of Subpart F, there is no doubt that the existence of tax deferral has been seen by the U.S. Government, the IRS and Treasury officials as having a major distorting effect. For example:-

> "The most important feature of our tax system giving preferential treatment to U.S. investment abroad is the privilege of deferring U.S. income tax on the earnings derived through foreign subsidiaries until these earnings are distributed as dividends. The lower the rate of foreign income tax, the more significant is the privilege of tax deferral".[80]

It was noted earlier that, in 1984 at least, the stated purpose of Subpart F was to "enforce capital export neutrality by preventing the shifting of earnings to a jurisdiction having no natural business nexus with the income"[81] - in other words, to remove the fiscal attraction of tax havens which might otherwise be used for profit extraction and profit diversion. This concern to achieve neutrality was also raised in the House of Representatives' Ways and Means Committee 1962 hearings.[82]

Given the official view that tax deferral was a serious problem because it was having a distorting (i.e. non-neutral) effect on capital export, it might be expected that the concept of neutrality would be followed rigorously in the legislation. At best there is some doubt as to whether neutrality is a significant concept underlying Subpart F. The matter is to be judged in two ways. First it is necessary to analyse the role of Subpart F in the context of the U.S. tax code itself to determine whether Subpart F fulfils its role as part of a wider, coherent tax code. Second, the "internal" aspects of the provisions of Subpart F should be considered to determine whether the specific rules achieve neutrality.

The Place of Subpart F in the Internal Revenue Code

With regard to the place of Subpart F in the tax code as a whole it is clear that shifts in policy have led to somewhat contradictory legislation elsewhere in the Code. Certainly, with regard to its taxation of overseas vehicles owned or invested in by U.S. people, U.S. tax policy does not seem to prioritise the achievement of tax neutrality.

The degree to which U.S. Government policy influences tax legislation affecting overseas investment should certainly not be underestimated. In the light of the 1971 DISC (Domestic International Sales Corporation) legislation, a leading international tax commentator observed in 1973:-

> "The U.S. Subpart F legislation on the setting-up of tax-haven sales subsidiaries has become far less relevant since the introduction of the DISC legislation .... In the U.S., trade war and balance of payments factors seem to have overruled anti-avoidance considerations".[83]

The DISC legislation was widely seen as a fiscal package to salvage the U.S. balance of payments position. The objective of the legislation was to create significant export incentives. Under the legislation, companies which derived 95% or more of their income from export related activities paid no U.S. tax on half their profits. This favourable postponement could continue indefinitely until the DISC distributed its profits or ceased to qualify as a DISC. The DISC legislation was replaced by the less advantageous Foreign Sales Corporation (FSC) rules by the 1984 Tax Reform Act.[84] The change was made as a result of pressure from trading partners of the U.S. who argued that the DISC tax benefit treatment constituted an illegal export subsidy in violation of the General Agreement on Tariffs and Trade (GATT).

It is difficult to see the justification by which the Subpart F legislation and the DISC legislation could be reconciled as each being complementary portions of a coherent tax code with an even approach to foreign investment and it seems more probable that the two areas of legislation merely represent two separate (and contradictory) official policies:

> "Ironically, while trade policy has accorded a high priority to opportunities for service exports, U.S. tax policy has proceeded

along a separate track and appears to have raised new obstacles to American competitiveness."[85]

Subpart F in Isolation

Turning to the "internal" characteristics of Subpart F, the most obvious aspect of the legislation is its discriminatory nature: If tax export neutrality is achieved at all, it is achieved only selectively. This follows from the scheme of the legislation itself. The very existence of the categories of "tainted income" to which Subpart F applies means that the provisions have an inherently uneven effect. Of course this does not of itself preclude the achievement of tax neutrality. If the discriminatory provisions (i.e. the categories of tainted income) were designed to prevent all cases of fiscal distortion (i.e. tax avoidance mechanisms and use of tax havens, etc) then the provisions might seek to achieve neutrality by dealing selectively with the perceived abuses. Whether the provisions of Subpart F do this in practice is open to doubt. For example, the very existence of s. 956 (investment in U.S. property taxed currently as a deemed distribution) is, ceteris paribus, itself a fiscal incentive to direct investment away from the U.S. As has been noted, the basis of this provision is the belief that the use of untaxed earnings by a CFC for the purposes of investing in U.S. property is "substantially the equivalent of a dividend".

Any international tax practitioner will confirm that the use of "upstream loans" and similar devices has indeed been an important method of effectively repatriating overseas profits. From the point of view of the fisc, such devices should be prevented. However, the very broad provision of s. 956 attacks and deters not merely these schemes but also projects of investment into the U.S. based on sound commercial principles. This point was recognised by the Joint Committee of Taxation in 1976, some fourteen years after the first enactment of the rule:-

> "The Congress believed that the scope of the provision was too broad. In its prior form it may, in fact, have had a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a controlled foreign corporation looking for a temporary investment for its working capital was, by this provision induced to purchase foreign rather than U.S. obligations".[86]

In recognition of the excessive breadth of the provision, the 1976 Act excluded from the definition of U.S. property stock or debt of a non-related domestic corporation and movable drilling rigs. In spite of the changes made, s. 956 operates in a number of situations in which it is hardly credible to argue that a constructive dividend to the U.S. shareholders has been made. For example, all the following would be caught:-

(a) the loan of funds to any U.S. person other than a domestic corporation, even where the U.S. person owns no stock, whether directly or indirectly, in the CFC;

(b) the licensing of technology developed by the CFC for use in the U.S. by an unrelated licensee in its business operations;

(c) the guarantee by a CFC of the debt obligation of a related domestic corporation or of any other non-corporate "U.S. person". The fact that such a guarantee is caught is in conflict with court decisions holding that such a guarantee is not considered to be a constructive dividend under general tax principles.[87]

Further examples could also be mentioned.[88]

The Subsidy Theory of Subpart F

Notwithstanding the official statements that Subpart F is designed to achieve capital export neutrality, a radically different interpretation is given by Professor Paul McDaniel.[89] McDaniel starts his analysis by stating that tax deferral granted to U.S. CFCs is inconsistent with the decision to adopt the foreign tax credit (indirect credit for taxes paid by foreign subsidiaries) as the basic mechanism for applying the U.S. tax system to international transactions. This is because a properly constructed foreign tax credit system would tax currently the income of U.S. corporations, giving credit for overseas taxes paid, without regard to remittances by way of dividend. This leads McDaniel to the view that:-

> "The income and activities left outside the scope of Subpart F are those that the U.S. wishes to subsidise with an interest-free loan (through tax deferral) or outright grant (if tax is deferred indefinitely). The intricate rules, exceptions, limitations and exclusions contained in Subpart F, under this view, are not rules necessary to limit exceptions to an otherwise proper tax rule (i.e. deferral) but instead function to impose limits on a subsidy programme that the U.S. has elected to run through its income tax system.... In very general terms, then, the income and activities that are excluded from Subpart F are those that the United States wishes included in its tax subsidy programme".[90]

McDaniel substantiates his theory by pointing to the CFCs that sell or buy products to or from, or provide services to, related corporations in the country to which the CFC is located. In this situation, the point of the subsidy is to help those CFCs compete with foreign competitors operating in the same market. However, where a CFC merely buys goods, for example, from a related party in one country and sells to a related party in another, no such purposes is served by any subsidy - hence the operation of Subpart F in such a case. The analysis is also applied to foreign base company income:-

"The FBCI rules focus on activities by the CFC outside the country in which it is located. Again, the purpose of this is clear when the deferral rules are seen as a subsidy programme. The subsidy is to enable a U.S.controlled subsidiary to compete in its country against other foreign companies operating therein. If the subsidiary is not really operating a trade or business in that country, then no subsidy will be given".[91]

McDaniel also states that the inclusion in CFC earnings of illegal payments and boycott income rests on a policy decision to limit the federal financial subsidy programme effected through the tax system because granting the subsidy in these cases would run counter to U.S. non-tax policy objectives.

McDaniel's theory is not, in the light of the legislative history of Subpart F, a convincing view of the intentions behind the enactment of Subpart F. It may nonetheless be a correct explanation of the operation of Subpart F in practice. The significant point relating to McDaniel's theory, for present purposes, is that far from supporting the "capital export neutrality" objective, McDaniel's theory runs in quite the opposite direction.[92]

It was stated that even on the "capital export neutrality" interpretation, there are a number of aspects to the legislation which act in opposition to its having a neutral effect. With regard to the very different theory that Subpart F is basically a part of a subsidy programme, the essence of the legislation clearly runs counter to the neutrality principle of IFL.

Subpart F as Anti-Avoidance Legislation

Notwithstanding the above discussion as to whether the legislation is fundamentally designed to achieve capital export neutrality or is the enactment of a subsidy theory, it might also be argued that Subpart F is simply an elaborate piece of anti-avoidance law. A recent explanation of the provisions that comprise

Subpart F talks of its "anti-tax haven" rules.[93] The current belief in the anti-avoidance character of the legislation is most clearly conveyed in the 1986 Conference discussion of the applicability of Subpart F to captive insurance companies:-

> "The conferees do not believe that U.S. persons utilising offshore captive insurance companies should be able to avoid current U.S. tax on the related person insurance income of these companies...."[94]

A similar sentiment is expressed with regard to the use of losses:-

> "The conferees believe that the present law deficit rules allow U.S. taxpayers operating abroad through controlled foreign corporations to shelter too much tax haven income from current U.S. tax".[95]

Although these quotes are taken from the recent Tax Reform Act of 1986 deliberations, similar remarks emphasising the anti-avoidance character of the legislation have been made throughout the legislative history of Subpart F.

The changes made by the recent Tax Reform Act of 1986 emphasise the aggressive attitude now being taken by the U.S. fisc to counter what are regarded as avoidance activities. The extension of Subpart F income to include all forms of insurance income has already been noted. In more general terms, the 1986 Act made a number of changes which expand the categories of Subpart F income, narrow the exceptions to the Subpart F, and alter thresholds. The combined effect of these changes is to increase the significance of the Subpart F rules and to increase the amount of income of CFCs which is now liable to be taxed currently under Subpart F.

If Subpart F is more properly viewed as being primarily anti-avoidance legislation, this does not necessarily mean that it will breach the principle of neutrality. Indeed, an incidental effect of the legislation may be to support that principle

through the correction of fiscal distortions arising from avoidance opportunities, although the earlier discussions of the categories of income which are subject to the operation of Subpart F may suggest that this proposition is hardly correct in the case of Subpart F. However, it is possible to evaluate the effect of anti-avoidance legislation from the perspective of the neutrality principle only when the impact of the legislation in question on legitimate business activities is known. This in turn requires an understanding of the concept of "legitimate". Since, in this thesis, the neutrality concept is a concept of IFL, the question whether or not business activity counts as "legitimate" must also be judged according to the criteria of IFL.[96]

In framing Subpart F, the U.S. fisc has clearly determined which activities or transactions of CFCs constitute legitimate business activity and which do not, the latter category being made subject to current taxation under Subpart F. This determination may not necessarily accord with the approach adopted from the perspective of IFL. This fundamental point is discussed in detail in the final part of this thesis.

OTHER ISSUES OF IFL RELATING TO SUBPART F

The Ability to Compete in Foreign Markets

Despite the statement of intent in 1961 that there was no intention to disrupt genuine business activities[97], it is apparent that the Subpart F legislation may have had such a disrupting effect.

Facing the current U.S. burden of tax on all its insurance income, a U.S. CFC may well be at a significant disadvantage in attempting to compete with its foreign rivals in respect of foreign business. When competing with foreign competitors in jurisdictions with a lower rate of tax than that prevailing in the U.S., U.S. CFCs may find themselves priced out of the market because the premiums for insurance required by U.S. CFCs are calculated to produce a (relatively higher) return due

to the need to take account of current U.S. taxation. In such a situation the effect of Subpart F may be wholly negative since there is a severe disadvantage to entering the market. In this situation, therefore, Subpart F acts not to tax currently overseas income but rather to rule out the possibility of such income being generated.[98]

The problems caused by Subpart F are not limited to the insurance sector. The banking and financial services sector is affected similarly. Interest received by a U.S. controlled foreign bank, whether from a related or unrelated party, is currently taxable as FPHCI (unless the bank receives interest in connection with financing exports of a related party). Any U.S. CFC which is active in this sector must generate a return which covers costs and provides a profit of an acceptable level. However, the fact that such profit will be subject to current U.S. taxation may require an increase in interest rates, for example, to keep the net return at an acceptable level. Again, this may lead to U.S. CFCs being underpriced (and therefore rendered uncompetitive) by foreign competition in jurisdictions where the tax rate is lower than that applying in the U.S. The conclusion of a recent survey on the effects on competitiveness of the 1986 Tax Reform Act (and particularly the 1986 Subpart F changes) in the context of banking services was that:-

> "the 1986 Act had a substantially negative effect on an industry already hard pressed by international competition".[99]

This is significant because the banking, financial, insurance, etc sectors have recently enjoyed considerable growth and expansion. Much of this growth has taken place in the traditional financial centres, such as London and Tokyo, where tax rates are generally high enough to avoid Subpart F problems. However, there are a number of other financial centres where tax rates are relatively low compared to the U.S. and where expansion and growth in the financial sector matches or exceeds that enjoyed by the traditional financial centres. The international financial services centre in Dublin is an excellent example. Given

that the corporate tax rate is only 10%, it is highly questionable whether U.S. CFCs can compete in places such as Dublin on equal terms with other foreign competitors.

Avoiding and Evading Subpart F

At the time of the introduction of Subpart F there were a number of cases of attempted de-control of CFCs to avoid the operation of Subpart F.[100] This indicates that in practice some shareholders of CFCs will prefer to rearrange their investment in a CFC to avoid current taxation in the U.S. In broad terms, such a reorganisation could be carried out in one of two ways.

First, some form of re-distribution of the equity of the CFC could be arranged so as to avoid (or mitigate) the operation of the Subpart F rules. For example, equity in the company could be sold by a majority shareholder to a number of third parties so that it would no longer be the case that 50% or more of stock in that CFC was owned by U.S. shareholders as defined. To compensate for the reduced stake in the CFC (and subject to any agreement that might be made with the new owners of the shares sold), it might be possible for the former majority shareholder to arrange that the profits of the company be extracted not exclusively by way of dividend but partially by way of management fees, etc paid for management services rendered by the former majority shareholder. Alternatively, it may be possible for the former shareholder to retain a significant interest in the company by advancing to the company a long term loan in exchange for loan stock. Interest paid on such stock would be an additional method for the extraction of the profits of the enterprise.

The above approach to avoiding Subpart F operation would be an entirely legitimate means of avoiding Subpart F but it would involve a real loss of control of the company, notwithstanding the fact that certain arrangements might be concluded largely to maintain the level of profits extracted by the former major shareholder or shareholders. However, the significant disadvantage would be the

loss of flexibility which would follow from the loss of control. Assuming the shareholders to be other than entirely passive with regard to the affairs of the company, the existence of more shareholders will, from the point of view of the former major shareholder, inevitably lead to more constraints on the activities of the company and a consequent reduction in flexibility. This demonstrates that the ability to compete with other companies not subject to Subpart F legislation may be affected not merely by the actual operation of Subpart F but also by arrangements entered into to avoid such an operation of the Subpart F rules.

The second type of method to side-step Subpart F current taxation is by unlawful means. For example, a sham "sale" of shares by a major U.S. shareholder to foreign parties who in substance act as mere nominees may achieve its goal in deflecting the operation of Subpart F if the "sale" were accepted as genuine by the tax authorities.

Information with regard to the prevalence of this type of method for avoiding Subpart F is inevitably not publicised. However, it would be somewhat naive to suppose that the introduction of Subpart F has not promoted such a reaction in certain cases. Indeed, in the light of the discussion on international tax avoidance, such a reaction, on the part of some taxpayers at least, is to be expected.

The key difference between the lawful and unlawful methods of avoiding Subpart F is that whereas the lawful method is inflexible and inconvenient and results in a significant change in the controlling interests of the company, the unlawful method maintains exactly the majority shareholders control of, and effective interest in, the company. The ability of the CFC to compete with other companies is also not affected. As such, there are clear economic advantages to this latter method if the taxpayer in question is prepared to entertain the use of unlawful methods to avoid the operation of Subpart F.

CONCLUSION

The scheme of this thesis is to postpone consideration of the key elements applying in common to the legislation of the U.S. and the U.K. until both countries have been considered. However, certain "localised" conclusions on Subpart F may be made at this stage.

The most striking feature arising from the analysis of Subpart F is the lack of any clear conceptual foundation. The legislation unambiguously opposes deferral in certain cases. What is not clear is whether the basis for this is on anti-avoidance grounds; or to achieve capital export neutrality; or as part of a subsidy programme (or, indeed, to increase U.S. tax revenues or to discourage foreign investment). Clearly, if the conceptual foundation of Subpart F cannot easily be identified, this will make the task of assessing the success of the legislation somewhat difficult.

The truth is that at different times all these bases have been used to justify the creation of, and adjustments to, the legislation. As such, there is a lack (conceptually at least) of any clear foundation for the legislation. This point can be illustrated by a recent example. The same 1986 Joint Committee which agreed amendments to Subpart F to extend the categories of FPHCI, on anti-avoidance grounds, specifically preserved tax deferral for interest derived in connection with certain export sales[101] without any apparent difficulty. After twenty-five years, the cumulative effect of this treatment of the legislation is the existence of an incongruous and highly complex set of rules.

It is of course to be expected that domestic fiscal policy will shift over a period of time. However, from the point of view of IFL, there are a number of reasons (not least, the problem of double taxation) why policy shifts affecting tax legislation of an international character should be circumscribed. The relationship between domestic tax policy and the policy dictates of IFL is considered in detail in the closing chapters of this thesis.

In May 1985, President Reagan identified three problems with the current U.S. tax system: It is unfair; too complicated; and impedes growth.[102] Unfortunately, what was said in macrocosm for the U.S. tax system appears equally true in microcosm in the case of Subpart F.[103]

It would be preferable if the rules of Subpart F were more clearly defined to achieve a specific objective. For example, if the rules are principally anti-avoidance rules (and this seems to be the case in practice) then Subpart F should be rationalised to concentrate on related party transactions. This would result in a simplified set of provisions, more readily comprehensible due to the obvious policy objective. This would entail the removal from Subpart F of all those provisions which are not related to the central objective (e.g. the provisions relating to illegal payments and boycott income) so that only related party transactions fell within the scope of Subpart F. On this approach, the provisions relating to investment in U.S. property, for example, would be changed so as to ensure only constructive dividends made to related parties in the U.S. were caught by Subpart F; at the very least this would mean an expansion of the exclusions from "U.S. property" caught by the operation of s.956.

At the same time, by concentrating on the conceptual rationale of Subpart F, it would become easier to discuss the operation of controlled foreign companies legislation in general - for example, the necessity for and the effectiveness of the legislation could be analysed rather more rigorously than is currently possible.

However, although such a change would certainly improve Subpart F, there still exists a number of issues relating to IFL that remain to be considered in connection with Subpart F and the taxation of controlled foreign companies in general. This consideration is postponed until the legislation of the U.K. has been considered.

CHAPTER 5 - NOTES

1 Although reference is made throughout the chapter to various secondary sources dealing with Subpart F, it may be helpful to the reader to note that the standard exposition of U.S. corporate taxation is contained in B.I. Bittker and J.S. Eustice, Federal Income Taxation of Corporates and Shareholders, 5th edition (Boston, 1987). The CFC provisions are discussed in Part D of Chapter seventeen. An international tax focus from a U.S. perspective is given in R.L. Kaplan, Federal Taxation of International Transactions (Minnesota, 1988) where the discussion of Subpart F is contained in Chapter 6 of Part II.

2 In the other cases mentioned, a U.S. corporation would be subject to U.S. tax in any event. This is because a U.S. corporation is taxed on its worldwide income, including income derived from a joint venture, foreign branch or agency, or partnership - see IRC, s. 11.

3 The regulations specify six characteristics which are ordinarily found in corporations:- associates; an objective to carry on business for joint profit; continuity of life; centralisation of management; limited liability; free transferability of interests.

4 M. Mulroney, Subpart F - Background, Basic Concepts and Terminology, Tax Management Portfolios, Tax Management Inc., U.S.A., 1982, p. A-12.

5 Note 4, Ibid.

6 See Revenue Ruling 73-254, 1973-1 C.B. 613.

7 Reg. s. 301 7701-2 (a) (1).

8 Reg. s. 301 7701-5.

9 Note 8, Ibid.

10 IRS, s. 957(a). There was an amendment proposed in the 1986 House Bill to amend the test to 50% or more but this revision was not enacted. See Committee Report (note 70), Ibid, at II-612.

11 The Regulations state that "consideration will be given to all the facts and circumstances of each case". (1.957 - 1(b)(1)). However, U.S. shareholders are deemed to own the requisite percentage of total combined voting power in certain cases, for example if they have the power to replace a majority of the directors of the foreign entity. These provisions are designed to catch U.S. shareholders who have effective control over the foreign entity, even if they do not hold more than 50% of the voting power or value of the total shares. Similarly, the

Regulations deal with attempts to shift formal voting power in order to "de control" the CFC: "Any arrangement to shift formal power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained." The main point arising from cases relating to this area of the legislation is the necessity to demonstrate that non-U.S. shareholders possess real voting power which can be, and actually is, exercised. See, for example, CCA Inc. 64 TC No. 12 (1975) as compared to Garlock Inc. v CIR 489 F. 2d 197 (2d Cir 1973).

12 See also the discussion in Bittker and Eustice (cited at note 1) at pp. 17-30.

13 For example, Michael Mulroney (see note (2)) at p.A17 comments: "Thus, in justifying the concept, and, therefore, the definition now in s. 957 (a) Treasury submitted a memorandum to the House which references the voting control concept to, inter alia, the Securities and Exchange Act of 1934, the Public Utility Holding Company Act of 1935, certain national banking statutes and the ownership provisions of s. 902, all of which were grounded on different considerations".

14 S. 542 (a) (2).

15 S. 957 (a) as amended by the Tax Reform Act of 1986 s. 1222(a)(1).

16 See U.S. Accounting Research Bulletin No. 51 as amended by Financial Accounting Standard No. 94.

17 Statement of Standard Accounting Practice Number 14, "Group Accounts", issued September 1978.

18 The position in Canada is broadly similar to that applying for accounting purposes in the U.S. and the U.K. - see Coopers & Lybrand Accounting Comparisons: U.S., Canada and U.S.A. (London, 1992) p. 53.

19 1 House Hearings on the President's 1961 Tax Recommendations, pp 340-341 (87th Cong., Ist Sess. (1961)).

20 Garlock Inc. v. C.I.R. 58 TC 423 1972 aff'd, 489 F. 2d 197 [2d Cir. 1973], cited in full in W.C. Gifford and W.P. Streng, International Tax Planning, Tax Management Inc, 2nd ed 1979, p. 409, at p. 410.

21 S. 954 (d) (3).

22 S. 953 (c)(1).

23 IRC, s. 953.

24 See section XII of Senate Report No. 1881, 87th Cong. 2nd Sess., (Report of Senate Finance Committee to Accompany HR 10650), Subsection C2 (reproduced in M. Mulroney; Subpart F - Background, Basic Concepts and Terminology, BNA Tax Management Portfolios No. 432 (Washington, 1986) p. B. 701 at pp. B-702-703).

25 Note 24, Ibid.

26 No further explanation is given in the Committee Report (op. cit. at note 70) as to why the change has been made.

27 This category is in turn explained in s. 957 (d) according to the meaning given in s. 7701.

28 Note 8, Ibid.

29 s. 7701 (a) (30).

30 Note 8, Ibid.

31 S. 6046, as amended in 1960.

32 H. Rep. No. 1447, 87th Cong. 2d Sess. 94, A-170 (1962).

33 S. 951 (b).

34 However, these complex rules on "control" and stock ownership will not generally cause difficulties in the case of wholly-owned subsidiaries of U.S.-based multinational companies either because they will be directly owned from the U.S. (making the rules on indirect or constructive ownership irrelevant) or because they will be 100% owned by another 100% overseas subsidiary (in which case the rules on indirect and constructive ownership can be readily applied) - see Bittker and Eustice (op. cit. at note 1, at 17-31).

35 Bittker and Eustice (op. cit. at note 1) concur by their observation (at 17-31) that the most important foreign corporations in size if not in number are wholly owned subsidiaries of domestic corporations.

36 In such a case it is of course necessary to apply these rules not merely at year-end but also from day to day since if a corporation is a CFC for any portion of a year the amount taxed in the hands of its shareholders is reduced under the rules in s. 951 - see Bittker and Eustice (op. cit. at note 1) at 17-31.

37 Note 19, Ibid.

38 Statement of Standard Accounting Practice Number 1, "Accounting for Associated Companies", issued January 1971, revised April 1982.

39 Similarly, if one or more U.S. shareholders own no more than 50% of all the stock,whether in value or voting power, and the balance of the stock was owned by foreign shareholders, CFC status would be avoided.

40 See IRC, ss.27, 901, 902(a) under which the indirect tax credit is available where 10% or more of the voting stock of the foreign company is owned by the U.S. shareholder. A similar rule applies in the U.K. tax legislation in respect of the underlying tax credit relief (ICTA 1988, s.790(6)).

41 See further the discussion in chapter seven.

42 As a result of the different bases of attributable income, there is a danger of double taxation. However, by s.959(a) subpart F income are excluded in the computation of the increase in earnings invested in U.S. property.

43 S.959 (a).

44 The Senate Finance Committee stated that earnings of a CFC invested in U.S. property were intended to be "taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them" (S. Rep. No. 1881, 87th Cong. 2d Sess., pp 87-88 (1962).

45 The complexity of the Subpart F provisions is stressed by Bittker and Eustice (op. cit at note 1) at the very outset of their exposition of the U.S. CFC provisions at section 17-31 (p.17-70).

46 The consequences arising from highly complex legislation are examined further in Chapters 8 and 9.

47 M. Edwardes-Ker, International Tax Strategy, In-Depth Publishing (Dublin, 1974), Chapter 4 section 6 p.28.

48 Deficit Reduction Act of 1984, "Explanation of Provisions Approved by the Committee on March 21st 1984", Committee on Finance, United States Senate Vol. I, 98-169 p.2.

49 See generally Chapter 4 and specifically the Gordon Report (A Report to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy), submitted by Richard A Gordon, Special Counsel for International Taxation, 12 January 1981) at pp.42-46.

50 U.S. Section, by Marshall J. Langer, in International Fiscal Association Seminar Paper; "Recourse to Tax Havens - Use and Abuse", (Kluwer, 1980) p.12.

51 An explanation of the operation of advance corporation tax is beyond the scope of this thesis. See Butterworths U.K. Tax Guide 1988-89, Seventh Edition, (London, 1988) pp.666-683.

52 A further example is the device whereby one alternates between years where there is a Subpart F inclusion due to investment in U.S. property and years in which an actual distribution from the foreign subsidiary is made. This manoeuvre is described in detail in Oyez Intelligence Report "U.K./U.S. Tax Planning under the Treaty" edited by J.R. Dewhurst, Oyez Publishing, (London 1981) p.35. Further comments on the favourable use of the Subpart F legislation are given in M. Mulroney "Subpart F - Ancillary Considerations", Tax Management Portfolio 434, Tax Management Inc., (U.S.A., 1983) p. A-8.

53 The same point could equally be demonstrated in connection with the U.K. CFC rules.

54 K. Klein, N.H. Kaufman, "Passive Foreign Investment Companies", Tax Management International Volume 16, No. 6, June 12 1987, p.223.

55 The comment is made based on the House Report and the Senate Report on the PFIC measures - see further note 56, Ibid.

56 See further note 54, Ibid, at p 237-238.

57 A similar reluctance on the part of the U.S. Treasury to recognise the bona fide nature of offshore transactions or structures is reflected in the U.S. taxation of captive insurance companies and the technical guidelines issued to IRS agents. These guidelines set out various challenges that an agent may raise to combat the use of captives - see Internal Revenue Manual, Chapter 45(11)9, MT 4500-199(1975), as cited in C.I. Lenrow, R. Milo, and A.P. Rua, Federal Income Taxation of Insurance Companies (New York, 1979), pp.137-138.

58 See now IRC s.954.

59 Further, as is reflected in the 1986 Committee Report, "tax deferral is preserved, to the extent otherwise available under present law, for interest derived in connection with certain export sales (see Committee Report - op. cit. at note 70 - at II-616.

60 The example deals with discrimination between different types of income derived from carrying on banking or other financial trading. There is of course a larger discrimination in the way that, broadly, all income from

manufacturing is not targeted by Subpart F - see further Bittker and Eustice (op. cit. at note 1) at 17-31.

61 S.952 (d).

62 See s.952 (c).

63 S.954 (c).

64 S.952 (c) (1) (B) (iii).

65 S.904 (d) (2) (c) (ii).

66 S.952 (c) (1) (B) (v).

67 Note 65, Ibid.

68 S.952 (c) (1) (B) (vi).

69 See IRC, s.952 passim.

70 See further Tax Reform Act of 1986, Conference Report to Accompany H.R. 3838, section C.1 as reprinted in The Tax Reform Act of 1986: Conference Committee Report, Prentice Hall edition at p.II 621-623.

71 Note 70, Ibid, at p.II-623.

72 Note 71, Ibid.

73 Conference Committee Report, The Tax Reform Act of 1986, Prentice Hall, 1986, II-623.

74 President's 1961 Tax Recommendations, reprinted in 1 House Hearings on the Tax Recommendations of the President, 87th Cong. 1st. Sess. (8-10) 1961, at pp.27-28.

75 There is very little explanation of the change in the Conference Committee Report and it is therefore difficult to know precisely why the law was changed - see Conference Report (op. cit. at note 70) at II-610, II-612 and II-621.

76 There is no explanation in the Committee Report (nor in the House Bill or Senate Amendment) as to why the test is restricted in this way - see note 75, Ibid.

77 The reference to £100,000 applies in the case of accounting periods ending upto 31 March 1991. The lower "small companies relief" limit under ICTA 1988, s.13 was increased to £250,000 by FA 1991, s.25.

78 See CPLR 8818003, as discussed in E. H. Fink, "U.S. Tax Scene", Intertax 1988/6-7 p.197. A similar point would arise in connection with the different treatment of depreciation for tax purposes.

79 Tax Reform Act of 1986, Conference Report to Accompany HR 3838, 99th 2d, Report 99-841, p.626. The Treasury Regulation referred to is TR Sec. 1.957-1 (b).

80 Note 74, Ibid.

81 Note 48, Ibid.

82 See generally discussion in chapter four and specifically note 74 Ibid.

83 Note 50, Ibid.

84 See now ss.921-927.

85 T. Horst and W. R. Cline, Taxes and U.K. competitiveness in the services Industries, Deloitte Haskins & Sells, Washington, January 1988 p I-3.

86 General Explanation of the Tax Reform Act of 1976, Prepared by the Staff of the Joint Committee on Taxation (December 29th, 1976), Section 4, Amendment Affecting Tax Treatment of CFCs and Their Shareholders.

87 Maguire, "Investments in U.S. Property under section 956: Pledge of CFC Stock and Facilitation of Borrowing in Light of Proposed Regulations" 79-8 Tax Management International Journal 3, at 6-7 (August 1979).

88 Further examples are given in T.st.G. Bissel, Controlled Foreign Corporations - Section 956, Tax Management Portfolio 232-3rd (Tax Management Inc., 1985) p. A-2, (from where the examples given are taken).

89 Professor Paul McDaniel, "United States of America" in International Tax Avoidance, A Study by the Rotterdam Institute for Fiscal Studies, Volume B: Country Reports (Kluwer, 1978) pp.241-243).

90 Note 89, Ibid, at p.243.

91 Note 89, Ibid, at p.246.

92 A major weakness of McDaniel's argument is the uncritical assumption that ultimate U.S. ownership of a CFC establishes a prima facie right to tax the income earned by that CFC. There are various policy issues lying behind this assumption which are central to the discussion in this thesis. A U.S. perspective on this point is contained in Park, "Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits", 78 Columbia Law Review, 1609.

93 Note 79, Ibid, p.612.

94 Note 79, Ibid, p.618.

95 Note 79, Ibid, p.623.

96 The discussion in chapters one and two should be borne in mind in this context. As has been argued in those earlier chapters, questions of what constitute legitimate activities, structures and arrangements may, from a tax perspective, be settled by recourse to the established policies and principles of IFL. This point is taken up in greater detail in chapters eight and nine of this thesis.

97 Note 74, Ibid.

98 In the absence of detailed economic information, the point cannot be pursued. Clearly, the strength of the point would turn on the nature of the competition (whether U.S. or non-U.S.) and the location of the competition (whether subject to a higher or lower tax rate, etc.).

99 Note 85, Ibid, p.I.15.

100 See, for example, Garlock Inc. v Comr 58 T.C. 423 (1972), affirmed 489 F.2d 197 (2nd Cir. 1973); Kraus v Comr 59 T.C. 681 (1973), affirmed 490 F.2d 898 (2nd Cir. 1974) and Estate of Weiskopf v Comr 64 T.C. 88 (1975) affirmed per curiam 76-1 USTC 9387 (2nd Cir. 1976).

101 Note 79, Ibid, p.616.

102 The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, Summary, May 1985, pp.1-2.

103 It should be noted, however, that no evidenced is adduced in this thesis in favour of the argument that Subpart F impedes growth. Whilst the author is inclined to the view that Subpart F is likely to have this effect, the proof or evidence required would go into the realm of economic analysis and therefore outside the scope of this thesis.

PART C

CONSIDERATIONS RELATING TO THE UNITED KINGDOM

CHAPTER 6

THE APPROACH TO TAX AVOIDANCE, ATTITUDE TO TAX HAVENS AND U.K. ANTI-AVOIDANCE LEGISLATION

INTRODUCTION

The scheme of this chapter is, broadly, to consider the attitude of the U.K. fisc to international tax avoidance and tax havens insofar as that attitude is currently expressed and, particularly, as it has been expressed in the consultative documents which state the rationale and justification of the U.K. CFC legislation.

The discussion of the current attitude of the Revenue to international tax avoidance is followed by an outline of the major anti-avoidance legislation which was available prior to the enactment of the CFC provisions and which remains in force. Consideration is then given to the three-year consultative background to the enactment of those provisions and, finally, there is a brief description of the CFC legislation currently in force.

A summary guide to the specific sections which comprise the current CFC legislation is given in Appendix III.

ATTITUDE TO INTERNATIONAL TAX AVOIDANCE

Tax Saving, Tax Avoidance and Tax Evasion

There is no statutory definition of tax saving, tax avoidance or tax evasion in U.K. law and the definitions of and distinctions between these concepts (which were considered in the earlier chapter on international tax avoidance), are as problematic in the U.K. as they are in most other jurisdictions.

The crucial distinction between avoidance and evasion is frequently pinned on a distinction between honesty and dishonesty, the former being the hallmark of avoidance activity, the latter of tax evasion:-

> "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his

> property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow - and quite rightly - to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Inland Revenue"[1] (emphasis added).

Tax evasion, on the other hand, is generally understood to involve a deliberate and dishonest understatement of revenue or overstatement of deductible expenditure. As might be expected, the U.K. fisc is implacably opposed to all forms of evasion activity and guilty parties are subject to financial penalties or imprisonment.[2]

Precisely what amounts to tax avoidance is, as noted, not entirely clear and the "emerging principle" of the Ramsay[3] line of cases (discussed below) has done little to clarify the position.

The most recent judicial overview of the subject was given by Lord Templeman in the Challenge Corporation case[4], a New Zealand case heard on appeal by the Privy Council.[5] Lord Templeman acknowledged the "well-known difficulties encountered in the formulation and enforcement of effective anti-tax avoidance provisions"[6] and went on to consider the distinctions which may be drawn between a transaction which is a sham, a transaction involving the evasion of tax, a transaction involving the avoidance of tax and one which mitigates a tax liability (a "tax saving" transaction).

The facts of the case (which concerned the use of a provision for tax relief as an instrument of tax avoidance) did not, according to Lord Templeman, involve a sham on the ground that the transaction "was not so constructed as to create a false impression in the eyes of the tax authority".[7] Lord Templeman went on to

say that tax evasion also was not in point as the company had fulfilled their duty of informing the fisc of all relevant facts:-

> "Evasion occurs when the Commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a re-assessment. Fraudulent evasion may lead to a criminal prosecution as well as re-assessment".[8]

His Lordship therefore concluded that the critical distinction at issue in the case was between tax mitigation and tax avoidance. Mitigation could be explained as follows:-

> "Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to a reduction in his tax liability".[9]

On the other hand, with regard to tax avoidance:-

> "In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax".[10]

With due respect to Lord Templeman, there remain a number of conceptual questions which arise from his categorisation of tax avoidance, tax evasion, sham transactions and tax mitigation, and, in consequence, his consideration of these matters is unlikely to break new ground in the analysis of these concepts.[11] Lord Templeman's understanding of the concept of avoidance is certainly somewhat narrower than that of most taxation practitioners and the Inland Revenue.[12]

However, the case is of some significance in indicating the current attitude of the courts to arrangements or transactions which reduce the tax liability of the taxpayer. Clearly, not all forms of such activity are attacked by the fisc and some are arguably encouraged.[13] In broad terms, it would appear that apart from avoidance activity which is attacked by specific anti-avoidance legislation, the type of avoidance activity which is not to be tolerated by the fisc is that which can be challenged under the Ramsay doctrine, to which attention is now turned.

The "New Approach"

Until 1981 it was generally thought that if a document or transaction was not a sham it would have effect for tax purposes. As such, it would not be possible for the fisc or judiciary to look behind it at the substance rather than the form of the transaction. This understanding of the law was based, inter alia, on the 1936 case, IRC v. Duke of Westminster.[14] In 1981, this understanding was reversed with the Ramsay decision which was later consolidated by the cases of Burmah and Furniss v. Dawson.[15]

The facts of the Ramsay case are complex. The case concerned an attempt by the taxpayer to generate a tax allowable loss to offset against a taxable gain. The characteristics of this scheme (and several other similar schemes used at the time) were described in the case as involving a ready-made scheme prepared in advance by tax consultants by which the taxpayer ended up in the same position as the one in which he started, having proceeded mechanically through all the various steps to the end:[16]

> "The scheme consists, as do others which have come to the notice of the courts, of a number of steps to be carried out, documents to be executed, payments to be made, according to a timetable, in each case rapid... In each case two assets appear, like particles in a gas chamber with opposite charges, one of which is used to create the loss, the other of which gives rise to an equivalent gain which

> prevents the taxpayer from supporting any real loss, and which gain is intended not to be taxable. Like the particles, these assets have a very short life. Having served their purpose they cancel each other out and disappear. At the end of the series of operations, the taxpayer's financial position is precisely as it was at the beginning, except that he has paid a fee, and certain expenses, to the promoter of the scheme".[17]

The court held that in such circumstances it could and should look at the series of transactions as a whole and was not confined to considering each separate step in isolation.

There is already a huge amount of material available on the Ramsay line of cases[18] and it is not proposed to consider the doctrine in further detail here save to observe that this line of cases has been interpreted and applied very broadly by the Revenue in practice (particularly in the international sphere). As such, the development of the doctrine has introduced a significant constraint on U.K. tax avoidance activities in general.

The recent House of Lords' decisions in Craven v. White (and associated appeals)[19] appear to have introduced significant constraints on the circumstances in which the Ramsay line of cases may now be applied, although it is still a little early to conclude on the practical effect of those decisions, particularly as regards the attitude to certain tax-saving schemes or transactions on the part of the Inland Revenue.

The development of the Ramsay principle demonstrates a concerted attack on relatively artificial tax avoidance schemes in respect of which the judiciary have broadly accepted the Inland Revenue's arguments that such schemes should not succeed. Notwithstanding the recent decisions in Craven v. White, there is no doubt that the principle represents a new, tougher attitude to tax avoidance efforts

by the taxpayer in general. For example, in the case of IRC v. Burmah Oil Co. Ltd[20] Lord Scarman made it clear that:-

> "It is of the utmost importance that the business community (and others, including their advisers), should appreciate, as my noble and learned friend Lord Diplock has emphasised, that Ramsay's case marks "a significant change in the approach adopted by this House in its judicial role" towards tax avoidance schemes".[21]

However, notwithstanding the attention given to the "new approach" of Ramsay and succeeding cases, it would be quite wrong to consider this the only significant recent development in the area of U.K. attitudes to avoidance. Arguably a more significant, if less sudden, development has been the gradual change in attitude to tax avoidance, particularly international tax avoidance, on the part of the Revenue which has taken place over the last two decades or so. Two recent examples of this will be given. The first, relating to the use of transfer pricing legislation demonstrates the expanded scope of the attacks now made by the U.K. fisc. The second, concerning the use of dual-resident companies, suggests the reasoning behind this change in attitude.

Use of Transfer Pricing Legislation

In recent years, there have been two significant new developments in the application of transfer pricing legislation in the U.K.

First, the fisc is beginning to extend its anti-transfer pricing efforts using new forms of attack. The "thin capitalisation"[22] challenge is a good example.[23] A company is regarded by the tax authorities as being "thinly capitalised" when its level of debt is unacceptably high in relation to its equity. The view frequently taken by the fiscal authorities is that payments of excessive interest on the debt to an offshore (usually associated) entity in such cases amounts to a disguised remittance of profits.[24]

There appears to be some confusion as to what will be accepted by the fisc as a "safe haven" ratio of debt to equity. Whereas formerly a 3:1 ratio was acceptable there is now a more rigorous requirement of a 1:1 ratio. To complicate the picture there are often different acceptable ratios for different sectors (for example, U.K. financial institutions are generally allowed a higher rate) and there are no clear guidelines on what is to count as "debt" or "equity". It is therefore frequently impossible to predict in advance what arrangements for the capitalisation of a company will be acceptable from a tax point of view.[25]

The inevitable result of this development is major uncertainty as to the tax treatment of inward investment into the U.K. coupled with, in some cases at least, manifestly inequitable results.

The second development that has been evident is the extension of traditional transfer pricing challenges to transactions between companies where both are located in relatively high tax jurisdictions. In such cases, the challenge is somewhat unexpected because there is generally no advantage to be gained by the taxpayer in artificially shifting profits from one high-tax jurisdiction to another.

The problem with this more aggressive use of transfer pricing legislation is that very significant practical difficulties are encountered in demonstrating to the tax authorities involved that a proper pricing policy has been adopted. There are some industries, notably the pharmaceutical and chemical sectors, in which there may be no independent market or arm's length prices available to compare with the transfer prices adopted for specific products. In such cases, it is frequently necessary to compile a huge amount of information to persuade the tax authorities that a proper pricing policy has been implemented. Even then, there is certainly no guarantee of success.[26]

Both major developments identified above demonstrate the degree to which the scope of the transfer pricing legislation has been extended in recent years by the fisc.[27]

Attitude to Dual-Resident Companies

The Revenue statements on the use of dual resident companies provide some indication of the reasoning behind the official attitude toward international tax avoidance and the use of tax havens.

Dual resident companies are companies resident in two jurisdictions by reason of the application of different criteria for residence. For example, a U.S.-U.K. dual resident company will be resident in the U.S. if incorporated there and also resident in the U.K. if centrally managed and controlled there. Where the dual-resident company makes profits, its position is no different to any other doubly taxed company since one country will generally give relief for the tax levied in the other. Typically, however, such companies borrow funds to finance investment by the multinational group of which they are a member. The interest payments made on the borrowings by the dual resident company create a tax loss which is normally set off under the group relief or corresponding provisions in both countries in which it is resident, thus effectively securing a double deduction for the interest payments.

There have been two Consultative Documents published on this subject, the first in November 1984[28] and the second, with accompanying draft legislation, in December 1986.[29] The most striking feature of the two papers is the assumption on the part of the fisc that the use of a dual resident company is largely motivated by the objective to avoid tax and that this necessarily results in a cost to the Exchequer and a loss or disadvantage to other taxpayers who do not arrange their group funding arrangements in this way:

> "Between them the two Exchequers are paying for the bulk of the cost of the borrowing... Multinationals are thus obtaining a very substantial tax benefit through the use of dual resident companies, with a corresponding loss of tax revenue to the Exchequers of the countries involved"[30] (emphasis added).

It is probably true that the overwhelming motivation for the creation of a large number of dual resident companies is the objective of securing a double relief for interest payments. The Consultative Document of November 1984 states that approximately 50 multinationals were investing into the U.K. through a dual resident company, with relief given for interest payments of approximately £150 m a year. However, what surely requires analysis in this context is the relationship between the existence of dual residence facilities and the amount of inward investment into the U.K. (The same argument can also be applied to outward investment using a dual resident company.)

It is highly likely that the existence of the dual residence facility promotes inward investment to (and outward investment from) the U.K. That same investment, whether inward or outward, may lead to greater wealth generation in the U.K., which may lead to an <u>increase</u> in aggregate profits chargeable to tax in the U.K. despite the double relief for the interest payments.

The above proposition may or may not be the case and no claims are made here for either side of the argument. In any event there would be a number of other questions which would require addressing - for example, the desirability of such incentives, the distorting effects of the incentives from an economic perspective, etc. However, the significant point is that the analysis of the "problem" and its effects is virtually non-existent in the two consultative papers. It is true that the 1984 paper mentions that a dual resident company can be interposed in an existing multinational structure with a "paper shifting of finance between different companies owned by the multinational which creates an interest deduction, and hence a tax loss, in the dual resident", yet it is admitted that this is an example "at the extreme".[31] There is no indication of the economic impact of the dual resident facility nor of the economic consequences of the draft legislation proposed to prevent the effective use of dual resident companies. Indeed, of the seven pages which comprise the 1984 paper, only half a page represents anything even remotely approaching an analysis of the position. The rest of the paper is given over to describing the phenomenon and suggesting "possible solutions". The 1986

paper, issued with a two-page Press Release, comprises four pages of discussion and fourteen pages of draft clauses. The (rather thin) analysis takes up no more than a quarter of one page.[32]

Another theme running through the two papers is the necessity to avoid prejudicing the affairs of "genuine" dual resident companies:

> "The new rules will not apply to dual resident companies which are genuinely trading...".[33]

However, the criteria by which such "genuine" companies are to be identified are not elaborated.

The discussion in the two Consultative Papers of the dual resident issue is indicative of the Revenue's attitude in general: avoidance activity is regarded as inevitably involving a loss of revenue to the Exchequer and it is therefore to be opposed. However, such opposition should not prejudice the activities of "genuine" trading companies.

It is submitted that the lack of any proper analysis of the phenomenon in the case of dual resident companies is also typical of a more general approach by which certain assumptions (often relating to the existence of tax avoidance) are readily made and adopted, quite without adequate criticism or analysis.

ANTI AVOIDANCE LEGISLATION

There are a number of provisions which are used by the U.K. Inland Revenue to attack arrangements or transactions with an international character. The most important of these are surveyed briefly below, although the list is not exhaustive.

(i) Transfer Pricing Legislation - ICTA 1988, s. 770

The U.K. legislation on transfer pricing is contained in s. 770 of the Income and Corporation Taxes Act of 1988 (formerly ICTA 1970, s. 485).

The first requirement for the operation of s. 485 is that the seller, or alternatively the buyer, should be a body of persons.[34] That includes all companies and partnerships but not individuals. The other party to the transaction need not be a company or a partnership.

Secondly, the buyer must be able to control the seller, or vice versa, or both must be under the control of some third party.[35] The definition of control means that s. 770 cannot generally apply to dealings by a 49% owned tax haven subsidiary with its U.K. shareholder, or to a U.K. company in its dealings with its tax haven parent if that parent company owns only 49% of its shares.[36] However, in such cases artificial transfer prices may be challenged by other provisions in the tax legislation. The object of the legislation as currently applied is to prevent the export of profits from the U.K. through excessive payments of whatever form between associated parties. Although the legislation is expressed primarily in terms of sales and purchases, its scope has been considerably extended by an amendment which applies all the provisions of s. 770, with the necessary adaptations, to a wide variety of situations including "the giving of business facilities of whatever kind as they have effect in relation to sales".[37] In practice this amendment is interpreted broadly by the Revenue.[38] The legislation may be invoked only on a direction by the Board of the Inland Revenue. If such a direction is made and the requisites of the section have been established then an adjustment of taxable profits, based on the arm's length principle, will be made.

In practice, section 770 is used very rarely indeed and there is not a single reported case illustrating its application. However, the existence of a power

to make a direction is normally sufficient to enable the Revenue to achieve a negotiated settlement without formal direction in cases of dispute. The section, therefore, operates "in terrorem" - the existence of a power to make a direction normally being sufficient to enable appropriate adjustments to be reached by negotiations without a formal direction being made. Analysis of the section is complicated by the lack of any general guidelines or principles, although the Inland Revenue has issued some informal notes on the section.[39]

If section 770 is found to apply, adjustment of the transfer price will be to an arm's length price. In ascertaining such a price the Inland Revenue will usually consider prices used in similar transactions between independent parties who are operating at arm's length (if such prices are available).

Alternatively, they may start with the cost of goods or services and add an appropriate mark-up to arrive at an arm's length price. In practice, any method will be used which leads to a satisfactory result.

(ii) ICTA 1988, s. 74

A payment between associated companies could be challenged by using legislation other then s. 770. Section 74 (formerly ICTA 1970, s. 130) would permit such a challenge on the grounds that a payment is not incurred wholly and exclusively for the purposes of the trade.[40] In the context of transfer pricing disputes, s. 770 is a more precise weapon and is generally used by the Inland Revenue in preference to section 74. However, in cases where the degree of control required for the use of s. 770 does not exist (e.g. dealings between a U.K. company and its 49% offshore subsidiary) s. 74 could be used in certain circumstances to challenge the transfer pricing arrangements.

(iii) Migration of Companies - ICTA 1988, s. 765

The legislation now contained in ICTA 1988, s. 765 was introduced in 1951 and made illegal certain transactions by a U.K. company unless the prior consent of the Treasury had been obtained.[41]

Such prior consent was required until 16 March 1988 before a U.K. resident company could:

(a) cease to be so resident,
(b) transfer all or part of its trade or business to a person not resident in the U.K.,
(c) permit a non-resident company over which it has control to create or issue any shares or debentures, and
(d) transfer to any person any shares or debentures of a non-resident company which it controls.

The provision was partially abolished by the Finance Act 1988[42], with the effect that (a) and (b) above are now no longer effective, although new charging provisions have been introduced and will apply in certain cases when a company ceases to be resident, except when Treasury consent has been given.[43] As a result of changes made in 1988, it is now no longer possible for a company incorporated in the U.K. on or after 16 March 1988 to have anything other than a U.K. residence for tax purposes.[44]

The purpose of the section (and the new charging provisions referred to above) is to prevent the loss of tax on corporate profits being earned or received outside the jurisdiction of the U.K. fisc in the hands of a non-resident company.

An application under s. 765 will not be required in respect of transactions falling within certain classes to which the Treasury has already given its general consent.[45]

The legislation is not aimed exclusively at tax havens but the fact that a tax haven is involved may increase the likelihood of permission being withheld or being given on a conditional basis.

It would appear that the section is the only example in the world of a criminal penalty for tax avoidance as opposed to evasion.[46] Persons guilty of an offence under s. 482 are liable to a fine of up to £10,000 and/or imprisonment for a period up to two years.[47]

There have in fact been no prosecutions under s. 482, although the practical effect of these very severe penalties is to secure a high level of compliance with the requirements of the provision.

(iv) Capital Gains Tax Act 1979, s. 15

The function of CGTA 1979, s. 15 is to prevent the use of overseas companies to avoid U.K. capital gains tax. This is possible because capital gains tax (even in the case of U.K. assets) is generally imposed only where the taxpayer is resident or ordinarily resident in the U.K. The section provides that where chargeable gains accrue to an overseas company which would be a close company if resident in the U.K., then every shareholder (whether an individual or a company) who is resident or ordinarily resident (and, in the case of an individual only, domiciled) in the U.K., is treated as if their pro-rata portion of the capital gain made had accrued directly to them. The pro-rata portion is determined by reference to the proportion of assets of the company to which the shareholder would be entitled on a liquidation of the company.[48] The section does not apply where the relevant chargeable gains are in fact distributed to the company's

shareholders within two years from the time the gains accrued to the company.[49] There are a number of other exemptions.

There is a parallel provision to section 15 in section 17 of the same Act. Section 17 imposes a similar charge to capital gains tax in the case of chargeable gains accruing to trustees of a settlement. In certain instances gains may be attributed to U.K. beneficiaries under the settlement if the trustees are not resident or ordinarily resident in the U.K. and if the settlor is domiciled and either resident or ordinarily resident in the U.K. at the time of the gain or when the settlement was created.

(v) Distributions - ICTA 1988, s.209

Under section 209, interest paid by a U.K. company on certain loans is treated as a distribution.[50] This means not only that such payments of interest do not qualify as a deduction in computing profits for tax purposes[51] but also that a payment of advance corporation tax is required to be made to the fisc within three months of the interest payment being made.[52] The rule will apply when interest is paid to a non-resident company of which the paying company is a 75% subsidiary or, in certain instances, to a non-resident company where both companies are 75% subsidiaries of a third company which is not resident in the U.K.

This provision is normally overridden by double tax agreements. However, it will usually apply to payments of interest to associated companies in tax havens where there is no applicable double tax agreement. The effect of the provision, therefore, is to limit severely the ability of a U.K. company to borrow from an associated company in a tax haven and obtain a deduction in the U.K. for the interest paid on the loan to the tax haven associate.

It should also be noted that the distribution provisions form the basis of the "thin capitalisation" challenge referred to earlier in this chapter.[53]

(vi) Offshore Funds - ICTA 1988, ss. 757-764

The legislation on offshore funds applies to material interests in such funds and operates to treat gains arising from certain offshore funds as income.

One of the principal features of offshore funds has been the ability to have the interest earned on the investment rolled up in the fund and ultimately paid out as capital, instead of being paid out as interest throughout the term of the investment. The attraction of this arrangement to the U.K. participant was principally that the rolled-up income would be taxed at the lower capital gains tax rates rather than at the full income tax rate. (This attraction is no longer valid given the fact that capital gains are now taxed as if the chargeable gain made is income subject to tax at the appropriate marginal rate, in the case of an individual and at the applicable rate of corporation tax in the case of companies.[54]

Under the provisions introduced in the Finance Act 1984, and consolidated in ICTA 1988, ss. 757-764 the general rule now is that gains arising from the disposal after 31st December 1983 of a "material interest" in a "non-qualifying offshore fund" are chargeable to corporation tax or income tax as investment income under Schedule D Case VI to the extent such gains accrue after that date.[55]

The legislation divides offshore funds into two groups: distributing funds, which must meet specified investment restrictions and distribute at least 85% of their income and profits, and other non-qualifying funds. An offshore fund is a non-qualifying fund unless it is certified by the Inland Revenue as being a distributor fund within the above criteria.[56] For a "material interest" to exist, the investor, at the time of acquiring an

investment in the fund must have a reasonable expectation of being able to realise it within seven years for an amount reasonably approximate to that portion which the investment represents of the market value of the entity's underlying assets.

(vii) Transfer of Income Abroad - ICTA 1988, s. 739

The legislative title to s. 739 (formerly ICTA 1970, s. 478) is a complete description of the purpose of the section: "provisions for preventing avoidance of income tax by transactions resulting in the transfer of income to persons abroad". The provision applies to individuals not companies, but it is of relevance to this thesis as one of the more significant anti-avoidance provisions in the U.K. legislation.

The section applies where individuals ordinarily resident in the U.K. have transferred assets outside the U.K. so that income which they have, or will have, power to enjoy is receivable by non-resident individuals or companies. In such cases, assessments may be raised on the U.K. transferor in respect of that income.[57] The section has been interpreted in an extremely broad fashion, much to the disadvantage of the taxpayer: it would appear that the income in question need not flow from the transferred assets and that the assets need not be transferred abroad but may instead be transferred between third countries. The section is certainly penal in nature and can therefore result in the taxation of much more than the actual benefit which the taxpayer has in fact received from the transaction. In connection with s. 739, one commentator (writing prior to the 1988 consolidation) has observed:

> "Amongst professional advisers perhaps the most feared anti-avoidance section of TA 1970 is s. 478.... in practice no argument has been too esoteric for the Revenue to pursue in connection with s. 478... ".[58]

Other Measures

In addition to the legislative measures discussed above, there are two important anti-avoidance doctrines which are based on common law rather than statute.

First, there is the recently developed general anti-avoidance approach enunciated in the cases of Ramsay,[59] Burmah,[60] and Furniss v. Dawson.[61] This has been discussed briefly earlier in this chapter.

Second, the U.K. concept of residence is frequently applied by the Inland Revenue in the context of companies located outside the U.K. but ultimately owned from the U.K..[62] As has been mentioned, there have been recent changes to the U.K. criteria applying to determine whether a company is U.K. resident. The traditional test has been that, for tax purposes, a company is resident in the U.K. if its "central management and control" is exercised in the U.K..[63] This test continues to apply but, with effect from 16 March 1988, there is the new rule[64] that U.K. companies incorporated on or after that date are necessarily regarded as resident in the U.K..[65] Notwithstanding the new rules, the Inland Revenue are likely to continue to use the doctrine of residence in the case of foreign subsidiaries of U.K. companies. If it can be shown that a foreign subsidiary whose directors meet abroad is in fact under the central management and control of the U.K. company or its directors and that the foreign directors are merely acting as agents executing decisions taken in the U.K., then the foreign subsidiary may be held to be resident in the U.K..[66] The effect of this would be to confer on the fisc the legal right to tax such a U.K. resident foreign company on its worldwide income and gains.[67] In the absence of a finding of U.K.-residence, the profits of the foreign company would be taxed in the U.K. only to the extent they are remitted to the U.K. or derived from a U.K. branch or agency.[68]

Summary

In summary, the measures traditionally used in the context of overseas subsidiaries of U.K. companies located in states with tax rates lower than those prevailing in the U.K. have been s. 765 and s. 770, although challenges under the residence doctrine have also been common. S. 765 and the new legislation imposing a tax charge in the case of certain migrations of companies[69] effectively permit the fisc to prevent a resident company taking all or part of its profit generating activities without tax cost outside the scope of the U.K. tax jurisdiction. S. 770 is used to regulate the pricing policy between U.K. companies and offshore associates to prevent any form of profit shifting from the U.K.. Throughout the life of an offshore company it is potentially liable to attack on the grounds it is in fact resident in the U.K.

The above description of the traditional application of anti-avoidance rules to overseas companies is entirely consistent with the principles underlying the substantive enactments of U.K. tax legislation relating to the taxation of non-resident companies. Under these relevant substantive enactments, such companies are not liable to U.K. corporation tax save on profits arising from a trade carried on in the U.K. through a branch or agency, or on gains arising from a disposal of U.K. assets used in connection with that trade.[70] These enactments are a fundamental part of the U.K. law and have been reinforced by all double tax agreements concluded with other countries. However, there are now[71] four statutory provisions which are arguably[72] exceptions to this basic approach, all of which are of an anti-avoidance character:

(a) ICTA 1988, s. 739, whereby income arising from assets transferred outside the U.K. is taxable on U.K. residents.

(b) CGTA 1979, s. 15,[73] whereby gains of non-resident companies which would have been close companies if resident in the U.K. can be taxed in the hands of U.K. participators.

(c) The offshore funds legislation of ICTA 1988, sections 757-764.

(d) The Controlled Foreign Companies (CFC) legislation of ICTA 1988, s.s. 747-756.

The CFC legislation is arguably the most significant of the four exceptions and it is to the background to that legislation that attention is now turned.

LEGISLATIVE BACKGROUND - THE ATTACK ON TAX HAVENS

Tax Havens

There is no definition of the term "tax haven" in the U.K. legislation. However, legislation has been promulgated with the apparent intention of reducing the use that can be made of transactions involving tax havens. Primary examples prior to the U.K. CFC legislation include the provisions of ICTA 1988 sections 739, 765 and 770, all of which were discussed in the last section.

Due to the perceived close connection between tax havens and international tax avoidance, the Revenue attitude to tax havens has tended to be determined by its attitude to international tax avoidance. The attitude to tax havens has possibly been somewhat less straightforward until recent years as a result of the fact that many tax havens are located in former colonies with which the U.K. has enjoyed a special relationship.[74] In consequence, an even handed approach to tax havens may have been on some occasions displaced as a result of other political considerations. However, this situation has now certainly been replaced by a uniform hostility to what the U.K. fisc regards as tax havens.

With the exception of Jersey, Guernsey and the Isle of Man with which the U.K. has limited double tax treaties (and also with the exception of Cyprus), the U.K. has not entered into tax treaties with any of the conventionally recognised tax

haven states (i.e. no or low tax havens). As a result, co-operation and exchanges of information between the U.K. fisc and tax haven authorities do not occur.

The clearest indication of recent official thinking on tax havens (and international tax avoidance) was given in the series of Revenue consultative documents produced from 1981 to 1983 in the course of discussion of the proposed CFC legislation and other proposed legislation. It is to these documents that attention is now turned.

The Consultative Process, 1981-1984

The process of consultation relating to the CFC legislation was not carried out in isolation but as part of a significant attempt by the Inland Revenue to overhaul certain key features of the law relating to international tax avoidance activities. This can be seen most clearly from the chart featured in Appendix II which outlines the various developments over the period January 1981 to July 1984. The generality of the Revenue's interest in this case is reflected in the titles of the two largest documents they published in this three year period, namely "International Tax Avoidance" and "Taxation of International Business".[75]

In the course of this consultative process, the Revenue pursued three issues in detail: company residence, upstream loans (loans made by an offshore subsidiary to a U.K. parent), and the issue of tax havens (in response to which the CFC legislation was advocated by the Revenue).

In 1981, the Revenue effectively set out to achieve the following objectives:

(a) to promulgate a statutory definition of residence

(b) to introduce anti-tax haven legislation in the form of the CFC provisions

(c) to prevent the use of upstream loans as a means of tax avoidance

(d) to repeal ICTA 1970, s.482, as it then was (now ICTA 1988, s.765).

(e) to prevent the transfer to the U.K. of loss-laden companies without some form of clearance machinery.

Of the above objectives, only objective (b) has been achieved at the time of writing, although objectives (a) and (d) have been partially achieved as a result of the 1988 changes discussed earlier.[76]

With regard to the residence issue, the Revenue proposed the enactment of a statutory definition of residence based on the OECD and European concepts of "effective management", "control and administration" and "principal place of business".[77] This proposal was dropped almost two years after being raised following particularly adverse public reaction.

The upstream loan proposals were based on the Revenue's perception that these loans represented overseas profits which, in the absence of tax charges on dividends (notably withholding taxes), would have been repatriated to the U.K. in the form of dividends rather than loans. The Revenue solution to this situation was the suggestion that such loans should be taxed as income.[78] However, the proposal was dropped at the same time as the changes on residence were shelved. Again, the reason given for not proceeding with the change was the "widespread unease amongst the business community".[79] This was also the reason given for the decision not to abandon s.765. However, to have retained s.765 yet to have proceeded with the CFC legislation is somewhat confusing since, on the Revenue's own reasoning, the CFC legislation is, partially at least, a <u>replacement</u> for the legislation contained in s.765.[80] The desire on the part of the Inland Revenue to oppose the importing of companies into the U.K. was not a matter on which detailed statements or papers were made publicly available and it was not proceeded with as a separate issue, although certain aspects of the CFC legislation would prevent certain abuses identified by the Revenue.[81]

Turning to the development and enactment of the CFC legislation itself, there were five separately identifiable stages to the process before the final enactment of the legislation in the Finance Act 1984 (which received Royal Assent on 26th July 1984). The legislation then enacted has been consolidated into ICTA 1988, s.s. 747-756 and Schedules 24, 25 and 26.

The first stage of the development was the issue in January 1981 of the consultative document "Tax Havens and the Corporate Sector".[82] This document announced for the first time that a new charge would be introduced on certain income of tax haven companies under United Kingdom control. Only one sentence in the entire document offers any kind of rationale for the introduction of such a measure:

> "The use of tax havens for tax avoidance companies has shown a marked growth in recent years, and the Government is particularly concerned to counter avoidance of United Kingdom tax by the accumulation of profits and investment income of United Kingdom groups in tax haven subsidiaries".[83]

There is no discussion or quantification of the "avoidance of United Kingdom tax" nor is there any discussion of the operative concepts "tax havens" and "tax avoidance".

Following a period in which representations were made, a second paper, together with draft clauses, was issued eleven months later in December 1981. The paper and clauses were contained in the document "International Tax Avoidance", which also contained papers and clauses dealing with the residence issue and upstream loans.[84] This paper makes clear that:

> "The purpose of these provisions is to remove the tax advantage of accumulating income in low tax areas".[85]

However, there is still no rationale put forward for the provision. There is, in the paper, a section entitled "the need for anti-tax haven legislation" but this does no more than note the various reactions received to the proposals and no case for the legislation is specifically put forward.

The concept of "privileged tax regime" which was first raised in the January 1981 paper is discussed further. It is explained that the proposed charge will arise only if the controlled foreign company is resident in a country with such a tax regime. However, whilst such a regime is identified in the January paper as one in which taxation is "significantly lower" than in the U.K., the December paper introduces a more objective test: an overseas company is regarded as enjoying a "privileged tax regime" if it is subject to tax in its country of residence at an effective rate of less then 50% of the corresponding U.K. tax in those circumstances.

The next paper in the series, distributed in June 1982, states an expanded purpose for the proposed legislation: not only is the legislation to remove the tax advantage of accumulating income in low tax areas, it is also to remove any tax advantages that might otherwise arise from the artificial diversion of trading or business activities from the U.K. to overseas companies. This paper is considerably larger than the earlier two but most of its length is taken up with a consideration of the main criticisms of the details of the proposed legislation, although there is one section given over to more general considerations. This section notes that "the need for legislation of some sort to counter tax haven abuse is generally accepted"[86] but that some representations continue to oppose further anti-avoidance measures for one or more of a variety of reasons. Four reasons are then given and considered. However, the analysis is hardly rigorous. For example, against the objection that the legislation might adversely affect the competitiveness of U.K. companies, the Revenue response is merely that "much of this criticism is misconceived, indicating that the purpose of the proposals has not been fully understood".[87] In answer to the objection that no evidence as to increased abuse has been adduced, the response is that:

> "It is difficult - by the very nature of international tax avoidance - to obtain a complete picture of the extent of current abuse... Nevertheless, there is no doubt that even before the abolition of exchange control, the number of tax haven subsidiaries controlled by U.K.-resident companies increased sharply".[88]

The document states that a detailed review of several U.K. multinationals is underway and hope is expressed that, when completed, that review will "throw more light on the extent of the current abuse".

A number of matters here require comment. Whilst it may be very difficult to "obtain a clear picture of the extent of current abuse", such a finding seems logically a prerequisite to the promulgation of any legislation. The review of multinationals should have been completed and its results considered in advance of the consultative process (and not in its closing stages). A further point relates to the statement that the number of tax haven subsidiaries controlled by U.K.-resident companies has increased sharply. This proposition (for which no empirical data is given) is simply not adequate. What is required to be shown is not that the incidence of the use of overseas subsidiaries has increased, but that there has been an increase in the use of such subsidiaries and that this development is, wholly or in part, attributable to the carrying on by those subsidiaries of "abusive" activities. It would in addition be necessary to demonstrate, rather than assert, why the activities carried on constituted "abuse".

In view of the profound effect the CFC proposals were to have on many U.K. multinational groups, it is somewhat staggering to see that the case for them has hardly been introduced, let alone concluded, after eighteen months of the consultative process.

Some of the defects discussed above are corrected in the "Taxation of International Business" document of December 1982. This document states that the case for introducing CFC measures remains compelling as a result of the

increased evidence of special arrangements, "in which normal commercial activities are distorted largely for tax reasons".[89] The "increased evidence" to which the document refers arises from the special survey undertaken by the Revenue to determine "the extent to which U.K. companies are making use of low tax countries to shield income from U.K. tax".

The survey is stated to confirm:

> "the earlier conclusion that such countries are currently being used on a large scale by a wide range of U.K. companies. There is evidence of companies being established in low tax countries both to accumulate income from the investment of surplus funds free of U.K. tax and to take some of the profits of other business income that would otherwise have been subject to U.K. tax".[90]

Five examples of such companies are given which are explained by the Revenue as follows:-

1. "Money box" companies (offshore investment companies whose return on investments is not taxed or taxed only at low rates).[91]

2. "Dividend trap" companies (holding companies which are interposed between a U.K. parent and its overseas trading subsidiaries to "trap" the dividends from those subsidiaries without subjecting them to taxation in the U.K.).[92]

3. Offshore captive insurance companies (used for insuring the risks of the group).[93]

4. Sales, distribution or service companies (used for the diversion of profits to low tax areas).[94]

5. Patent holding companies (used to shelter royalty income from U.K. taxation).[95]

There is an attempt to quantify the amounts of money involved in these companies but on the Revenue's own admission the incomplete and estimated figures make it very difficult to translate the available information into estimates of the annual tax at stake.[96] However, undeterred by the imprecise (or in some cases non existent) information the document states that:

> "This information suggests that sizeable sums of money are currently at stake, and that the annual loss to the Exchequer may already be of the order of £100 m."[97]

On the information given it is impossible to see how this figure is computed or derived.

Space does not permit a full discussion of the five types of companies identified by the Revenue nor of the amounts of money identified by the Revenue to be at stake. Such companies clearly do exist but whether they should be perceived in the pejorative light suggested by the Revenue paper is another matter. All the types of company cited can be viewed in less partial terms. For example, "money box" companies use funds which are either earned (and therefore taxed) in the U.K. or earned elsewhere (and therefore of no concern to the U.K. fisc.). Moreover, so called "money box companies" often do rather more in practice than facilitate the diversion of profits from high to low tax jurisdictions. For example, they may be used to raise funds from outside the group, for example by bond issues. Similarly, "dividend trap" companies are an established and legitimate means of ensuring that profits earned in overseas countries are subject to no greater effective tax charge than the standard U.K. corporation tax rate of 35%. Similar comments can also be made regarding the remaining three types of company cited. Moreover, whether the existence of such companies leads to a reduction of U.K. tax revenues is a matter on which no conclusion can be drawn

on the basis of the Revenue consultative papers due to the lack of any empirical or analytical evidence.

It has already been observed that the completion of the Revenue survey should, logically, have occurred in advance of the consultative process. However, given that the survey was at last carried out it is difficult to see what value it has. There is almost no analysis of the central point the survey should have addressed, namely the correlation between the existence of certain offshore companies and the reduction in U.K. revenues. What information there is is inconclusive and incomplete. Moreover, on the Revenue's own admission:

> "These limitations mean that the recent special survey by the Inland Revenue - which covered only a small sample of the U.K. corporate sector - cannot be presented as evidence about the full extent of current arrangements designed to reduce U.K. tax".[98]

This means that the case for the legislation remains largely unproven. It is of course recognised that carrying out a survey of a representative portion of the U.K. corporate sector is fraught with difficulties of obtaining information, interpreting it, drawing valid conclusions, etc. Nonetheless, it remains the case that the introduction of the CFC legislation represents a fundamental change to the U.K. taxation of overseas companies. As such, the burden of proof with regard to the necessity for such legislation lies with the proponent of the change (namely, the Inland Revenue).

According to the June 1982 document, the purpose of the CFC legislation is to prevent the diversion of income to, and accumulation of tax in, tax havens. This opposition on the part of the U.K. Inland Revenue to the diversion and overseas accumulation of profits is not in itself novel. However, the official perception of the scope of transactions which constitute unacceptable activities takes on a much broader aspect in the official CFC consultative documents as compared to previous statements on the matter. This can be demonstrated by reference to the

earlier discussions by the Royal Commission on the Taxation of Profits and Income in 1955 concerning the provision which is now ICTA 1988, s. 765 (formerly ICTA 1970, s. 482) and which was discussed earlier.[99]

What is of interest to the current circumstances is the view expressed on s. 765, particularly with regard to the propriety of companies seeking to become non-U.K. resident and earn profits outside the U.K. tax jurisdiction:

> "But although the word avoidance thus appears in the section, the avoidance that is in question can hardly be ranked with any of the kinds of avoidance that we have been speaking of. It consists simply in taking steps to earn profits as a non-resident of the United Kingdom when the profits have hitherto been earned as a resident of the United Kingdom.... we do not see what we can be expected to say about a section of this kind. It has no real connection with the subject of tax avoidance, and we take it that we ought to regard it as a temporary regulation to deal with an emergency, the existence of which made it imperative for the Government to take measures to maintain the yield of revenue, even at the cost of an interference as extreme as this. The reasons which lead a company, hitherto resident, to wish to emigrate may be in part that the United Kingdom rate of tax on its profits, if earned abroad, is higher than the rate of tax borne by its competitors: but they may also be due to the political or other advantages of the control of a company being actively present in the area where it conducts its main activities".[100]

The above comments of the Royal Commission (which were supported unanimously by the members of the Commission) are of relevance because they suggest the acceptance by the Royal Commission that there may be reasons for a company moving its residence outside the U.K. other than the avoidance of a liability to U.K. taxation. It must be remembered that the Commission was here

considering what is arguably the more extreme case: U.K. resident companies wishing to emigrate and earn profits without being subject to U.K. taxation. In the case of most CFCs, on the other hand, the CFCs would never have been subject to U.K. taxation in the first place.[101]

The Royal Commission accepts there may be various reasons for a company wishing to emigrate from the U.K. It is noteworthy that one of the reasons given (and quoted above) is the wish to face a lower tax burden as a result of being no longer U.K.-resident for tax purposes. This is clearly regarded as a legitimate reason, particularly in view of the comment that the section "has no real connection with the subject of tax avoidance".

By the time of the CFC provisions in 1981-1984, this attitude has completely disappeared. The wish to pay less tax has in all circumstances become an unacceptable reason for any arrangements from the official perspective.[102]

The underlying assumptions behind the current official opposition to what is perceived as international tax avoidance are not stated expressly but are nonetheless clear. In the foreword to the "Taxation of International Business" document, John Wakeman, Treasury Minister states:

> "One essential component of a stable framework for international business is a balanced fiscal regime which distributes the inevitable tax burdens in a just way. Unfortunately, the efforts of a few people are directed towards paying less than their fair share which operates to the disadvantage not only of the Exchequer but also of other taxpayers. The Government would not be fulfilling its responsibilities if it either failed to curb such tax avoidance or tackled it in a heavy-handed way. As the Chancellor said in his 1982 Budget Speech: "We must tread a very careful path between safeguarding the interests of the taxpaying community on the one hand and avoiding economic damage on the other".[103]

Elsewhere in the document it is stated that:

> "Fiscal justice demands that, in fairness to the vast majority of taxpayers who make their full contribution to the U.K. Exchequer, the Government take some action".[104]

From these statements, it would appear that the particular type of tax avoidance activity which is being discussed is perceived as an inequitable activity carried on by a "few people" to the detriment of the "vast majority of taxpayers". These basic assumptions about the phenomenon of tax avoidance through the use of offshore companies (which generally correspond to the assumptions of the U.S. fisc in this matter) will be considered in more detail in the final part of this thesis.

The other major concept underlying the discussion of offshore companies is that of the tax haven. The January 1981 paper states that the Government is particularly concerned to counter avoidance through the use of tax haven subsidiaries[105] and this provides the rationale for the introduction of the CFC provisions. Throughout the consultative process, tax havens are regarded as being synonymous with "low tax countries" and, beyond this characteristic, very little is said of what a tax haven is.

The basic test of a "tax haven" (contained in "Taxation of International Business") hinges on a comparison of the actual tax borne by the overseas company in its country of residence with the tax that the company would have paid had it been U.K. resident. However, it is stated in that document that, for the purposes of achieving a greater amount of certainty, the Revenue will publish a list of countries which would not be regarded as low tax countries under this legislation. This list was duly published in July 1984.[106]

The list raises a number of questions relating to the concept of a tax haven, but the discussion of these is more properly reserved for the next chapter.

In concluding on the consultative process, it should be noted that the changes made to the proposed legislation from its first announcement in January 1981 to its enactment in 1984 were not fundamental and the key elements of the proposed legislation in the initial document of January 1981 appear in the legislation which was ultimately enacted in 1984.

The U.K. as Tax Haven

In spite of the declared policy of the U.K. fisc to prevent international tax avoidance and the use of tax havens, the Economist Intelligence Unit has recently reported that Britain is the finest "pure" tax haven in the world, offering incentives at least as good as those of the Cayman Islands or Luxembourg.[107] The report rates Britain higher than most tax havens because of its vast range of tax and financial incentives.

The Report notes that Britain has the world's largest network of double taxation agreements with other countries, making it a prime location in treaty shopping and international tax planning. Moreover, it is stated that the British tax system is one of the most favourable in the world for business, with a top rate of corporation tax of 35%, and a reduced rate of 25% for smaller companies.[108] The Report accepts that highly artificial tax mitigation schemes are no longer viable due to the change in judicial opinion but argues that there remain a significant number of tax planning opportunities.

The major observations drawn by the Report are certainly correct. The U.K. continues to be widely used in particular for international tax-treaty planning and, for companies wishing to set up business operations in Europe, the U.K. is often considered to be the most fiscally-advantageous location.[109]

This situation is of importance for a number of reasons. It demonstrates the differences that exist in the view of what constitutes a tax haven (the U.K. fisc do not appear to consider the U.K. a significant tax haven) and suggests a fiscal

policy designed to be directed against tax havens (the CFC rules, for example) is somewhat anomalous, at least, if Britain itself enjoys some form of "tax haven" status.[110] Further, the somewhat paradoxical situation of a "tax haven" state having an anti-tax haven attitude itself reflects the practical difficulties of pursuing a completely coherent fiscal policy when it is desired to fulfil a number of different and irreconcilable policy objectives (for example, the prevention of international tax avoidance and the creation of a fiscal environment which is attractive to non-resident investors).

THE CURRENT U.K. CFC PROVISIONS

The provisions relating to CFCs are set out in ICTA 1988, ss. 747-756 and Schedule 24, 25 and 26. A brief overview of these provisions is set out in Appendix III. Under the legislation a company is deemed to be a controlled foreign company if it meets the following three conditions in any accounting period:-[111]

(i) It is resident outside the U.K.

(ii) It is controlled by persons resident in the U.K.

(iii) It is subject to a lower level of taxation in the territory in which it is resident.

If a company is a CFC by the above tests then the charging provisions of the legislation may apply to apportion to U.K. shareholders the overseas profits of that company, together with its creditable tax, if any.[112] The apportionment will apply only if a direction to that effect is made by the Board of Inland Revenue.[113]

However, before the direction can be made certain further conditions need to be met:-[114]

(iv) The company is not resident and carrying on business in a country listed on the "excluded countries" list published by the Inland Revenue.

(v) The company cannot satisfy any of four statutory exemptions, which comprise:

- motive test[115]
- exempt activities test[116]
- acceptable distribution test[117]
- public quotation condition[118]

(vi) The company does not fall within certain de minimis exemptions.[119]

The six elements identified above will be considered in outline before a brief analysis of the consequences to a company of being a CFC which cannot satisfy any of the statutory exemptions and which is not resident and carrying on business in a country listed on the "excluded countries" list published by the Inland Revenue.

(i) Resident outside the U.K.

A CFC has the requisite foreign character for the purposes of the legislation if it is resident outside the U.K.[120] Other than to ascertain that the company concerned is not resident in the U.K. (and is therefore "resident outside the U.K." for the purposes of ICTA 1988, s. 747(1)(a)), the tests of residence which apply generally for the purposes of the tax legislation (U.K. incorporation or U.K. central management and control) do not apply to determine what constitutes residence in this context. There is instead a statutory rule:

"In any accounting period in which a company is resident outside the United Kingdom, it shall be regarded... as resident in that territory in

which, throughout that period, it is liable to tax by reason of domicile, residence or place or management ".[121]

If there is no such territory, it is conclusively presumed that the company is resident in a territory in which it is "subject to a lower level of taxation" (discussed at (iii) below).[122] If there are two or more such territories, the company is regarded as being resident in only one of them, which is the country where the company's effective management is located or, if that test does not resolve the matter, in that country where the greater amount of the company's assets are situated.[123]

(ii) Control

The definition of control is adopted from existing legislation which deals with close companies. "Control" is directed[124] to have the meaning given in ICTA 1988, s. 416, subject to one amendment. The amendment consists of substituting for the test whether five or fewer participants do (or could) control the company the very much broader test of whether all the U.K.-resident shareholders together could exercise control. The effect of this statutory definition is that if any number of U.K. resident shareholders together control (or could control) the overseas company, it will be sufficiently "controlled" for the purposes of the legislation notwithstanding that such shareholders are not acting in concert nor could in practice exercise common control.[125]

(iii) Lower Level of Taxation

The third requirement of a CFC is that it is subject to a lower level of taxation.[126] The meaning of the phrase "lower level of taxation" is explained in the legislation as follows: "a company .... shall be considered to be subject to a lower level of taxation in [a particular territory] .... if the amount of tax (the "local tax") which is paid under the law of that territory

in respect of the profits of the company which arise in any accounting period is less than one half of the corresponding U.K. tax on those profits".[127]

To arrive at the figure of corresponding U.K. tax it is necessary to determine the profits of the company by applying U.K. tax rules. Chargeable gains are excluded from the operation of the CFC rules. Once the profits have been determined, it is necessary to establish what tax would have been payable in the U.K. on the assumption that the company was a U.K. resident company and did not obtain double tax relief for the local tax paid.[128] If the amount of U.K. tax so determined exceeds twice the amount of local tax, the company is regarded as subject to a lower level of tax for the purposes of the legislation.

(iv) The Excluded Countries List

The excluded countries list, a non-statutory list, was published by the Inland Revenue in July 1984.[129] The list was published to meet objections made during the consultative process that the necessity to determine whether or not a country was a "low tax territory" for the purposes of the legislation (which would have fallen on the taxpayer) would have been an unacceptable burden. The list therefore comprises countries which the Revenue consider should not be within the scope of the legislation. The Revenue has stated that:

> "The purpose of the list of excluded countries is to give assurance under the CFC legislation in respect of companies in countries named on the list".[130]

The list is divided into two parts. Companies resident and carrying on business in countries on Part I of the list are completely outside the scope of the legislation. Companies resident and carrying on business in countries

on Part II of the list are outside the scope of the CFC rules only if the company does not benefit from any of the tax benefits specified on the list.

A company can take advantage of the list only if it is "resident and carrying on business" within one of the countries. For the purposes of the list, there is yet another definition of "resident": a company will be regarded as resident in a country on the excluded countries list if under local law it is liable to tax there by reason of its domicile, residence or place of management, or, if taxation in that country is not imposed by reference to these criteria, by reason of its incorporation there.[131] A company is regarded as "carrying on business" in a country on the excluded countries list if 90% or more of its commercially quantified income accrues in, arises in or is derived from, and is taxable in that country.[132]

The excluded countries list is designed to be (and has been) amended from time to time to take account of tax changes overseas or if "exploitation" comes to the notice of the Revenue.[133]

(v) Exemptions

Apart from the protection afforded by the Excluded Countries List, a CFC will not be charged under the provisions of ICTA 1988, s.s. 747-756 if one of the four following statutory exemptions can be satisfied: - motive; exempt activities; acceptable distribution; and public quotation conditions.

1. Motive Test

The motive test is satisfied if it appears to the Revenue that:-

(a) In so far as any of the transactions (or any two or more transactions taken together) of the CFC achieved a reduction in U.K. tax, either the reduction

was minimal or it was not the main purposes, or one of the main purposes, of the transaction (or transactions) to achieve that reduction, and

(b) It was not the main reason, or one of the main reasons, for the company's existence to achieve a reduction in U.K. tax by a diversion of profits from the U.K..[134]

2. Exempt Activities Test

The exempt activities test is so framed as to preclude the possibility of it being satisfied by, broadly, companies with passive income (technically, "investment business")[135] or companies buying and re-selling goods (e.g. re-invoicing companies). A CFC is regarded as engaged in exempt activities in an accounting period if each of the following conditions is fulfilled:[136]

(a) Throughout the period, the CFC has a business establishment in the territory in which it is resident; and

(b) Throughout the period, the business affairs of the CFC are effectively managed there; and any of (c), (d) or (e) below are satisfied;

(c) The main business of the company does not consist of investment business or dealing in goods for delivery to or from the U.K. or to or from connected persons;

(d) In the case of a company which is mainly engaged in wholesale, distributive or financial business in an accounting period, less than half of its business is derived from connected persons;

(e) The company is a "local" holding company which derives 90% of its income from controlled foreign companies which are carrying on

exempt activities or the company is an "international" holding company which derives 90% of its income from "local" holding companies or companies carrying on exempt activities.

3. Acceptable Distribution Test

A CFC will meet the acceptable distribution test in an accounting period if it pays a dividend during, or within eighteen months after the expiry of, that accounting period and the dividend amounts to at least 50% of the available profits of the CFC (in the case of a trading company). The dividend is required to be 90% of available profits in the case of any CFC which is not a trading company.[137]

4. Public Quotation Condition

A CFC will meet this test if in a particular accounting period:

(a) At least 35% of its shares (in terms of voting power) are held by the public throughout that period; and

(b) Such shares have been dealt in on a recognised stock exchange; and

(c) Such shares are quoted in the official list of such a recognised stock exchange during that accounting period.[138]

(vi) De Minimis Exemptions

No direction can be made to apportion chargeable profits of a CFC to U.K. shareholders if the chargeable profits of the accounting period do not exceed £20,000 (as rateably reduced for accounting periods of less then twelve months).[139]

The second de minimis limit applies not to prevent a direction being made but to prevent an assessment on, and recovery of tax from, a U.K. resident company. This will apply where the chargeable profits of the CFC which are apportioned to the company (and its associates or persons connected to it) are less than 10% of the total chargeable profits of the CFC in that period.[140] If the 10% limit is not met, there may be an assessment but this will be limited to the chargeable profits apportioned to the company; chargeable profits apportioned to associated or connected persons will not be assessed in the hands of that company.[141]

CHAPTER 6 - NOTES

1 Lord Clyde in Ayreshire Pullman Motor Services and D. M. Ritchie v IRC (1920) 14 TC 754 at pp 763-4.

2 See generally, for example, Part X of the Taxes Management Act 1970.

3 W. T. Ramsay Ltd. v IRC [1981] STC 174; IRC v Burmah Oil Co. Ltd. [1982] STC 80; Furniss v Dawson [1984] STC 153.

4 CIR v Challenge Corporation Ltd. [1986] STC 548.

5 The case is nonetheless of considerable use from a U.K. perspective given (1) the fact that the ultimate appellate body for a New Zealand tax case, the Privy Council, is the same in all but name as the House of Lords, the ultimate appellate body for a U.K. tax case and (2) the relevance of the concepts considered in the case to U.K. law - for example as regards TCGA 1992, s. 137. The case has also been cited in recent U.K. cases, such as *Ensign Tankers v Stoker* [1992] STC 226 at 240.

6 Note 4, Ibid, at p. 553.

7 Note 4, Ibid, at p. 554

8 Note 4, Ibid, at p. 554

9 Note 4, Ibid, at p. 554

10 Note 4, Ibid, at p. 555

11 For example, enough has already been said earlier in this thesis on the inherently unsatisfactory nature of relying on the intention of Parliament to make any form of distinction. Further, the explanation of tax mitigation in terms of circumstances which "entitle" a reduction in a tax liability begs the question - what are those circumstances and how can they be defined, or at least identified? Moreover, the analysis of tax avoidance based on the financial position of the taxpayer being unaffected is hardly consistent with arrangements which do affect the financial position of the taxpayer and yet are classed as avoidance activities (for example the creation of a dually-resident company; the purchase of a "capital loss" company, etc). Finally, of the five cases of unacceptable tax avoidance given by Lord Templeman, one (CIR v. Duke of Westminster, 19 TC 490) was won at the time by the taxpayer and, even in Ramsay, the House of Lords did not overrule this case.

12 See further Chapter 2, passim.

13 The tax incentives to encourage taxpayers to participate in the Business Expansion scheme are a case in point. See ICTA 1988, ss 289-312. The incentives have been removed for shares issued after 1993 by F(No.2)A 1992, s.38.

14 (1936) 19 TC 490.

15 Note 3 Ibid.

16 See Lord Wilberforce, [1981] STC at p. 179.

17 Note 16, Ibid.

18 One of the more recent worthy additions to the list is "Tax Law in the Melting Pot", a study by the Revenue Law Committee of the Law Society, 1985.

19 Craven v White, Bayliss v Gregory and IRC v Bowater [1988] STC 476.

20 [1982] STC 30.

21 Note 20 Ibid., at p.39.

22 See further O.E.C.D. Committee on Fiscal Affairs; Thin Capitalisation, Issues in International Taxation (No. 2), (Paris, 1987).

23 Although the "thin capitalisation" challenge is not itself new, it is certainly the case from a practitioner's perspective that the scope and frequency of the challenge has been considerably expanded in recent years, to the point that the challenge is routinely raised by local Inland Revenue Inspectors of Taxes (and not merely by the specialists with the Inland Revenue's Technical Division) and in connection with transactions which, until recently, would probably have not been challenged - for example, factoring transactions may now be attacked by the Revenue on a quasi "thin capitalisation" basis.

24 The technical basis of the thin capitalisation challenge derives from the U.K. law on distributions, which is considered later in this chapter.

25 There is no official U.K. material available on the subject of "Thin Capitalisation". A summary (and critique) of the current Revenue practice is provided in representations on this subject compiled by the author on behalf of Deloitte Haskins & Sells. See Deloitte Haskins & Sells, "Thin Capitalisation", (London), March, 1988. Further, the Inland Revenue has done little to help the position. Not only has there been a recent shift from the 3:1 ratio to a 1:1 ratio as referred to in the text, but at different times other tests seem to be ranked by the Revenue as more important - for example, the "interest cover" test. In these circumstances, a clear

statement of the thin capitalisation doctrine as applied by the Revenue is impossible.

26 For example, in cases of dispute involving the tax authorities of the U.K. and Germany it has occasionally been impossible to arrive at a solution acceptable to both tax authorities. Since the mutual agreement procedure in the U.K. - German double taxation agreement is not mandatory, no mechanism is available to the taxpayer to force the tax authorities concerned to reconcile their differences. In consequence, double taxation of the taxpayer can arise.

27 Interestingly, the legislation itself has not changed materially but there has been a change in the scope of its application. The text, and note 24 above give examples of this change. It is considered by the author that this change in scope is attributable to the various factors discussed in Chapter 2, for example, the growing internationalisation of business activities coupled with the perception on the part of the fisc of increasing tax avoidance, particularly in the international sphere.

28 Inland Revenue, "Taxation of International Business: Dual Resident Companies"; Consultative Document, November 1984.

29 Inland Revenue, "Taxation of International Business: Dual Resident Companies"; Consultative Document, December 1986.

30 Note 28, Ibid, pp 3-4.

31 Note 28, Ibid, p. 3.

32 Note 29, Ibid, p. 1 paragraph 2.

33 Inland Revenue Press Release; "Taxation of International Business": Dual Resident Companies; 5th December 1986, p. 2.

34 ICTA 1988, s. 770 (1) (a).

35 Note 34, Ibid.

36 The definition of "control" for the purposes of s. 770 is given in ICTA 1988, s. 840. Under s. 840, control includes the power to secure the affairs of the other company can be conducted in accordance with the first company's wishes. Thus there can be situations in which a 49% owned tax haven company is controlled for this purpose.

37 ICTA 1988, s. 773 (4).

38 ICTA 1988, s. 770(2)(d).

39 See Inland Revenue; "The Transfer Pricing of Multinational Enterprises" issued in 1981 and reproduced in Intertax 1981/8, pp 301-306.

40 ICTA 1988, s. 74 (a).

41 The legislation was formerly contained in ICTA 1970, s. 482.

42 FA 1988, s. 105 (6), (7) and Sch. 14 part IV.

43 FA 1988, ss 105-107 and 130-132.

44 See FA 1988, s. 66.

45 ICTA 1988, s. 765 (4).

46 Rotterdam Institute for Fiscal Studies, International Tax Avoidance, Volume B (Kluwer, 1978) p. 209.

47 ICTA 1988, s. 766 (3).

48 CGTA 1979, s. 15 (3) - CGTA 1979, s. 15 is now TCGA 1992, s. 13.

49 CGTA 1979, s. 15 (5) (a)

50 ICTA 1988, s. 209 (2) (e) (iv)

51 ICTA 1988, s. 338

52 ICTA 1988, s. 14 (1)

53 The normal treaty "override" of the provisions is itself usually overridden by provisions which apply, broadly, where the quantum of the debt is excessive (see, for example, Article 11(5), (7) of the U.S.-U.K. double tax agreement) and it is this "second" override which the Inland Revenue will normally seek to apply in mounting a thin capitalisation challenge. The Revenue may also seek alternative ways of mounting a thin capitalisation challenge, for example, based on the associated enterprises Article of the relevant treaty.

54 In the case of individuals, see FA 1988, s. 98. In the case of companies, see ICTA 1988, s. 6 (1), (4) (a).

55 ICTA 1988, s. 761.

56 ICTA 1988, s. 760.

57 ICTA 1988, s. 739(1)

58 R. K. Ashton, Anti-Avoidance Legislation, (Butterworths, 1981), p. 67.

59 W. T. Ramsay Ltd. v IRC, [1981] STC 174.

60 IRC v Burmah Oil Co. Ltd. [1982] STC 80

61 Furniss v Dawson [1984] STC 153.

62 Aggressive Revenue challenges on the basis that the "central management and control" - and therefore residence - of the overseas company concerned is exercised in the U.K. are relatively common and a "residence" challenge may in that sense be regarded as an anti-avoidance mechanism, although U.K. residence is technically merely one of two preconditions of liability to U.K. corporation tax (the other being, broadly, carrying on trading activities in the U.K. through a branch or agency).

63 De Beers Consolidated Mines Ltd. v Howe 5 TC 198.

64 Note 44,

65 For a discussion of the new rules see P. Yerbury, "Company Residence and Migration - The New United Kingdom Rules", [1988] BTR 321.

66 Bullock v The Unit Construction Co. Ltd. 38 TC 712.

67 ICTA 1988, s. 8(1).

68 ICTA 1988, s. 11.

69 Note 42, Ibid.

70 ICTA 1988, ss. 6, 11.

71 The offshore fund legislation and the CFC legislation were enacted in 1984. The other two measures, however, have existed for some time. The original precursor to ICTA 1988, s. 739 was FA 1936, s. 18 and the original precursor to CGTA 1979, s. 15 was FA 1965, s. 41.

72 In substance, these measures have a similar effect, although technically they apply in quite different ways. It should be noted that the four provisions do not tax offshore companies nor do they necessarily impose corporation tax. Section 739 imposes income tax on certain U.K. individuals (in circumstances which do not apply in relation to income received by non-resident companies), Section 15 CGTA 1979 imposes capital gains tax on individuals or corporation tax on companies in respect of their attributable share of gains of foreign companies, and the offshore funds legislation taxes as income gains which would otherwise be taxable under the capital gains regime. It is only the controlled foreign companies

legislation which charges corporation tax on profits of foreign companies, but this tax is imposed on U.K. resident corporate shareholders.

73 Now TCGA 1992, s. 13.

74 This is illustrated by, for example, the fact that the U.S. tax treaty with Bermuda is entered into by the U.K. on behalf of Bermuda. A stronger example is the existence of a report on the offshore Dependent Territories in the Carribean by Mr Rodney Gallagher of Coopers & Lybrand. The Report was commissioned by the Government and includes some strong conclusions and recommendations. For example, in the case of Anguilla it is recommended that there should be an immediate moratorium on bank licences, a Task Force to review financial sector activity, introduction of new legislation and repeal of existing laws. See Report of Mr Rodney Gallagher of Coopers & Lybrand on the Survey of Offshore Financial Sectors in the Caribbean Dependent Territories (London, 1990), H.M.S.O.

75 Board of Inland Revenue, "International Tax Avoidance", November 1981; and Board of Inland Revenue, "Taxation of International Business; December 1982.

76 See in particular notes 43 and 44, Ibid.

77 Board of Inland Revenue, "Company Residence" January 1981, p. 1 para 5.

78 Note 70, Ibid, p. 59.

79 Note 75, Ibid, p. 9.

80 Board of Inland Revenue, "Tax Havens and the Corporate Sector", January 1981, p. 1, para 2.

81 For example, one of the concerns expressed by the Revenue (in Taxation of International Business, p. 6, para 8) was that an overseas company which has accumulated profits may transfer its residence to the U.K. and then, provided there is a group relief election in force, distribute these accumulated profits to U.K. group members without any tax becoming payable.

82 Note 80, Ibid.

83 Note 80, Ibid. p. 1 para 2.

84 Note 70, Ibid.

85 Note 70, Ibid, p. 10 para 5.

86 Board of Inland Revenue, "Tax Havens and the Corporate Sector", June 1982, para 7.

87 Board of Inland Revenue, "Tax Havens and the Corporate Sector, June 1982, para. 7.

88 Note 87, Ibid, para 5.

89 Note 75, Ibid, p.7.

90 Note 75, Ibid, p.12.

91 A good example of such a company would now be a company established in the Dublin International Financial Services Centre where income is taxed at a 10% rate of tax under FA 1980, ss.39B, 40 and 41, or a company established as an International Business Company in the Channel Isles where it may be taxed at very low rates of tax (as negotiated with the tax authorities).

92 The best known example is probably a Dutch holding company, which is often interposed between a U.K. company and its overseas subsidiaries. Such companies were used as a dividend trap mechanism but since the enactment of the CFC rules are now often used to facilitate the "mixing" of tax credits (i.e. aggregating high and low tax credits) for the purposes of the rules in ICTA 1988, s.801 on repatriation of foreign dividends to the U.K.

93 Many such captives have been established by U.K. companies in the Isle of Man and the Channel Isles, where they are typically subject to tax at rates in the order of 2-3%.

94 These types of companies may be established under special regimes, such as that applying to Belgian Co-ordination Centres under legislation enacted by Royal Decree 187 of December 30, 1982.

95 Such companies may also be established in offshore companies in order to enjoy more favourable tax provisions for the depreciation of intellectual property - for example in Holland where the depreciation in the relevant financial statements is normally followed for tax purposes.

96 Board of Inland Revenue, Taxation of International Business; December 1982, p.15.

97 Note 96, Ibid, p.16.

98 Note 96, Ibid, p.15.

99 Final Report of the Royal Commission of the Taxation of Profits and Income (Cmnd. 9474 of June 1955).

100 Note 99, Ibid, paras 1045 and 1046.

101 It might be argued that the comments from the Royal Commission are not relevant because they do not deal with the question whether a U.K. company should be taxed in respect of profits which it might "arrange" to accrue in the hands of a non-resident subsidiary. Such an argument is rejected by the author as the argument itself appears to be premised on the views that such an "arrangement" itself justifies U.K. taxation in these circumstances. Whilst there are, technically, instances in which this may be true, it is by no means universally true. The point is of course one of the central themes of this thesis and the relevant discussion and conclusions are contained in Chapters 1, 8 and 9.

102 Very recent legislative changes seem to underline the point. In the 1993 Budget statement the Chancellor announced new measures to prevent tax avoidance, including provisions to ensure the "lower level of tax" test for the purposes of the CFC legislation (see ICTA 1988, ss. 747 and 750) was to be amended from a test of less than one half of corresponding U.K. tax to less than three quarters (see now 1993 Finance Bill, Clause 118).

103 Note 75, Ibid, Foreword.

104 Note 75, Ibid, p. 9.

105 Note 83, Ibid.

106 Inland Revenue Press Release, 16th July 1984.

107 Economist Intelligence Unit, Britain as a Tax Haven, (London, 1986).

108 FA 1988, ss 26 and 27.

109 However, the U.K. is generally not regarded as an appropriate location for a European holding company due to the imposition of advance corporation tax on profits paid out of the U.K.. This situation may change as a result of recent proposals for reform: See Inland Revenue, "Corporation Tax Surplus A.C.T.: Proposals for Reform" (London, March 1993).

110 It should, however, be noted that the U.K.'s status as a tax haven is not attributable to measures which the U.K. CFC legislation is directed at, i.e. a no or low tax charge on corporate profits. Notwithstanding this point, it is considered the apparent anomaly still stands.

111 ICTA 1988, s. 747 (1),(2)

112 ICTA 1988, s.747 (3).

113 ICTA 1988, s.747 (1).

114 ICTA 1988, s,748(1).

115 ICTA 1988, s,748(3).

116 ICTA 1988, s,748(1)(b).

117 ICTA 1988, s,748(1)(a).

118 ICTA 1988, s,748(1)(c).

119 Under ICTA 1988, s.748(1)(d) no direction may be made if the profits of the CFC in the relevant accounting period do not exceed £20,000. If a direction has been made, ICTA 1988, s.747(5) prevents an assessment where the U.K. shareholder's interest is less than 10% of the relevant chargeable profits for the period.

120 ICTA 1988, s.747 (1) (a).

121 ICTA 1988, s.749 (1).

122 ICTA 1988, s.749 (3).

123 ICTA 1988, s.749 (2).

124 ICTA 1988, s.756(3).

125 ICTA 1988, s.756 (3) and ICTA 1988, s.416.

126 ICTA 1988, s.747 (1) (c).

127 ICTA 1988, s.750 (1). The "less than one half" test is to be amended to "less than three quarters" as a result of Finance Bill 1993, Clause 118.

128 ICTA 1988, s.750 (2) and (3).

129 See note 106, Ibid.

130 Note 106, Ibid.

131 Inland Revenue Press Release; Excluded Countries List; 16 July 1984.

132 Note 131, Ibid.

133 Note 131, Ibid.

134 ICTA 1988, s. 748 (3).

135 "Investment business" is defined in ICTA 1988, Sch. 25 para. 9. The definition includes holding or dealing in securities, the leasing of property, the investment of funds, holding intellectual property, etc.

136 ICTA 1988, Sch. 25, para 6, (1) - (4).

137 ICTA 1988, Sch. 25 para 2 (2).

138 ICTA 1988, Sch. 25, para 13(2).

139 ICTA 1988, S. 748 (1) (d).

140 ICTA 1988, s. 747 (5).

141 ICTA 1988, s. 747 (4) (a).

CHAPTER 7

U.K. CFC PROVISIONS - DETAILED CONSIDERATIONS

INTRODUCTION

The analysis of the U.K. CFC legislation contained in ICTA 1988 cannot precisely mirror the approach taken earlier in the case of Subpart F. This is because the scheme of the U.K. legislation differs significantly from the U.S.legislation and therefore an identical approach would be inappropriate. For the same reason, the two legislative codes dealing with CFCs do not readily lend themselves to a detailed comparative analysis. (However, a brief evaluation of the comparative approaches of Subpart F and the U.K. CFC legislation follows in the next chapter.) However, an attempt has been made to group the analysis of the U.K. CFC provisions under parallel headings to those used in the consideration of Subpart F. This treatment will facilitate the drawing of conclusions in the last part of this thesis. As with the U.S. material considered in Chapter Five, this chapter is intended to consider the U.K. CFC provisions from the perspective of IFL, and, in particular, by reference to the primary objective underlying IFL and the policies and principles of IFL. There are certain areas where this view from the perspective of IFL leads to similar issues or conclusions as apply in the case of the U.S. CFC legislation and these are discussed in Chapter Eight by reference to both the U.K. and U.S. law.[1]

U.K. CFC PROVISIONS AND IFL

Despite the relatively lengthy period of consultation, certain matters of principle appear to have been largely ignored in the discussion of the proposed legislation. For example, there is virtually no official comment on whether the measures amount to an extension of the U.K. tax jurisdiction or whether they are constitutional (for example, on the basis that, in effect, they amount to extra-jurisdictional taxation). Although certain responses to the early Revenue papers argued that the proposed legislation would be unconstitutional, this was never a criticism the Revenue replied to. From the available published representations, opinion as to the constitutional legitimacy of the measure (to the small extent it was expressed) was split, although the issue was never discussed in anything

approaching proper detail. The legitimacy of the measures from the perspective of the principles and policies of IFL is discussed at some length in the next chapter of this thesis.

Unfortunately, most of the published submissions made to the Revenue appear largely to concentrate on matters of detail and not to consider the overall principles of the changes proposed.[2] This is to be regretted because it is a poor reflection on the operation of the consultative process in general and it indicates that wider issues, not least the relationship between the proposed legislation and the principles and policies of IFL, were largely ignored.[3]

Indeed, from the perspective of IFL, the three year consultative process was not a conspicuous success. As well as this failure to consider the wider ramifications of the legislation, the quality of analysis and argument of the consultative process could certainly have been improved.

One of the major concerns voiced appears to have been with the evidence adduced by the Revenue to justify the change. There was much comment on this and the suspicions of a number of respondents are reflected in the comments of the Accepting Houses Committee/Issuing Houses Committee:

> 'The tax haven proposals go well beyond the mere combating of tax avoidance... If - contrary to our belief - specific avoidance targets are in mind, then we urge that they be identified so that... specific solutions may be sought.'[4]

It was pointed out in the last chapter that the evidence advanced by the Revenue in support of their case was introduced relatively late in the consultative process and did not in itself demonstrate conclusively any need for the legislative changes proposed. Moreover, the fact that a special study was commissioned to gather evidence of the extent of the perceived problem some months <u>after</u> legislation in response to that problem had been prepared suggests a somewhat illogical

approach. It is worth noting that the Revenue survey appears to have been commissioned only after the public clamour as to the lack of substantiation of the Revenue case. This may also suggest that, but for this reaction, the Revenue would have proceeded with the proposals in any event, regardless of the available evidence relating to the matter. Indeed, in the light of the discussion of the Revenue's approach to dual resident companies in the last chapter, this is perhaps no idle speculation. As demonstrated, the quality of argument surrounding proposed changes to the tax legislation (particularly with regard to anti-avoidance legislation) is often quite appalling, with little or no empirical or economic analysis.

The Revenue's contributions to the debate over the U.K. CFC measures do nothing to build confidence in this area. This is illustrated, for example, by the sole Revenue attempt to quantify the total benefit to the Exchequer in tax terms of the CFC legislation. In the foreword to the December 1982 document, 'Taxation of International Business', it is stated that:

> 'the use of controlled foreign companies in low tax countries, where avoidance is the main purpose of the activity, is leading to a tax leakage of around £100 million a year.'[5]

Typically, there is no further explanation of how this figure is derived or computed or how it has been ascertained that the figure relates to activities 'where avoidance is the main purpose'. Arguably, from the perspective of the principles and policies of IFL, one of the key failures of the development and promulgation of the U.K. (like the U.S.) CFC legislation is its wholly unilateral character. This feature is considered in more detail later in this thesis.

One particular result of this unilateralism is that the impact of the U.K. CFC legislation on the network of double tax treaties to which the U.K. is a party is virtually ignored. The subject of double tax agreements is raised briefly in one paragraph in the December 1982 document, 'Taxation of International Business'.[6]

In that paragraph it is stated that the Government do not think it would be right to exclude a company from the charge because it operates in a country with which the U.K. has a double tax treaty. Nor, according to the paper, is it possible to revise these treaties to counter all the arrangements that cause concern. The alternative solution to terminate these treaties is regarded as being too drastic and damaging to the U.K. business community generally.

The matter is simply not discussed further and, surprisingly, there is no discussion whatsoever of the relationship between the U.K. CFC charge and the existing provisions of double tax treaties.[7] At the very least, it would seem necessary to explain the scope of the business profits article of these treaties in the light of the operation of the U.K. CFC legislation or to explain why the U.K. CFC legislation is irrelevant to the operation of double tax treaties. However, the lack of discussion suggests both that the Inland Revenue perceive no difficulty in reconciling the CFC legislation with existing double tax treaties and also that the possibility of bilateral action has not been seriously contemplated. Both these matters require further consideration but since the discussion relates to both the U.S. and the U.K. legislation, this will be deferred until the next section of this thesis.

U.K. CFC PROVISIONS AND EQUITY

In appraising the U.K. CFC provisions from the perspective of equity, the primary questions relate to the type of companies caught by the legislation and to the U.K. shareholders on whom a charge is levied. The former requires consideration of such matters as corporate 'control' and the type of transactions or arrangements which are now subject to the charge; the latter leads to a discussion of the criterion by which U.K. shareholders are either included or excluded, i.e. the 10% de minimis shareholding.

Control

There are various definitions of 'control' in existing U.K. tax law. The expression is normally taken to mean the ability (secured by holding shares or voting power or under powers in the company's articles of association) by one or more means to ensure that the actions of the company are in accordance with the wishes of the relevant person (or persons). This is, broadly, the definition given in ICTA 1988, s. 840. In relation to close companies, however, a considerably expanded definition of control applies and it is this definition which the Revenue has chosen to apply to the CFC legislation. The wider close company definition contained in ICTA 1988, s. 416 is used for the purposes of the U.K. CFC legislation with one adaption: whereas for close company purposes 'control' is determined by reference to 'five or fewer participators', for CFC purposes that term is substituted by the term 'persons resident in the U.K.'.[8] This means that a CFC is regarded as controlled by 'persons resident in the U.K.' if such persons taken together can exercise 'control, whether direct or indirect, over the company's affairs'.[9]

The wide notion of control means that control could be attributed to a U.K. shareholders having a relatively minor interest in a CFC because of the attribution to him of the interests of persons, possibly including non-resident persons, with whom he is deemed to be associated for that purpose.

The gauging of control is a theoretical test as to whether all the participators resident in the U.K. could together exercise control if they so chose. Under the legislation, it is irrelevant if these participators are not acting in concert or if, in practice, they are unable to do so (perhaps because they are unaware of each other's existence). There is also the difficulty that the close company definition of control used takes into account a number of attributes other than voting control such as the ability to exercise or acquire direct or indirect control over the affairs of the company concerned.[10] Therefore in some cases it may be genuinely unclear where control lies.[11]

Given that the CFC legislation is primarily concerned with the accumulation of income in offshore companies it is not surprising that the Revenue have employed the wider close company test of control (rather than the more general test in ICTA 1988, s.840) since the close company legislation is itself particularly concerned with such accumulations in close companies. However, for the reasons discussed above, the modified test of control used in the CFC legislation is nonetheless rather too broad and too hypothetical.

The 10% Shareholder

As with the U.S. legislation, there arises the question whether the 10% de minimis figure in the case of a shareholder's interest[12] is set at the right level.

The Revenue view that a 10% de minimis limit is the correct figure appears to be justified by the statement that it is consistent with the distinction between 'portfolio' and 'direct' investors. The Revenue also points out that a higher figure would encourage fragmentation schemes to avoid the charge.[13] A further argument put forward in favour of the 10% figure in the U.K. context is that this percentage holding is the minimum level at which a company is entitled to underlying double tax relief.[14]

However, it remains questionable whether a 10% shareholder, who has no power or right to obtain information on the CFC or to compel it to pay a dividend, should be caught by the legislation. The Revenue's reliance on consistency with the distinction between 'portfolio' and 'direct' investors is perhaps not appropriate. The Chapter heading in the legislation is of course 'Controlled Foreign Companies' and the emphasis should therefore be on control (or degrees of control) rather than on the question whether the investment is of a 'portfolio' or 'direct' character, (a 'direct' investment is far from being synonymous with a controlling or significant investment in any case). The emphasis should more properly be on whether the shareholder has significant influence (or a similar right to participation) in the company's affairs. Current international accounting

concepts would, on this approach, suggest a figure of approximately 20%.[15] A figure of 25% is suggested by the Committee of London Clearing Banks.[16] Obviously, if individual shareholders were shown to be acting in collusion, their aggregate interest could be taken for the purpose of this test.

In the June 1982 document, the Revenue appears to acknowledge the validity of arguments that the 10% limit is too harsh in the case of an isolated shareholder with a 10% interest. The Revenue response to this is simply the posing of the question: 'But is not such a case purely theoretical?'.[17] This is hardly a satisfactory response to the question. Moreover, on the basis of the information and research presented in the consultative documents it is impossible to say whether such a case is or is not 'purely theoretical'. (The Inland Revenue consultative papers present no evidence or discussion relating to the type or pattern of shareholdings in overseas CFCs.)

In the consultative document which followed the June 1982 document it is stated that because the foreign company must both be under U.K. control and also fail the motive test before being subject to the CFC charge it is 'most unlikely' that tax would be charged on minority shareholders in isolation.[18] However, as will be seen from the discussion of the motive test later in this chapter, the proposed reliance on that test is of little comfort in almost any context.

In view of the lack of arguments supporting the 10% limit (beyond the Revenue assertion such a limit is necessary to prevent fragmentation schemes) it is difficult to avoid the conclusion that:

> 'The proposal to attack haven profits of a United Kingdom shareholder whose interest is as little as 10% has nothing to do with control... It is an attack on low-tax jurisdiction investment as such'.[19]

Overseas Tax - The 'Lower Level of Taxation'

One of the obvious inequities of the legislation is the legislative view taken of what tax paid in the overseas territory is to count for the determination of whether the CFC is subject to a lower level of taxation. Only local tax paid in respect of the profits of the company is taken into account.[20] This restriction on qualifying taxes will generally be acceptable in the case of states which operate a similar type of tax system to the U.K. However, some states levy a much higher proportion of their tax revenues by stamp duties and turnover, property and payroll taxes not linked to profits. Such taxes will be ignored in the determination of whether or not the CFC is subject to a 'lower level of taxation'.

It is of course the case that double taxation relief is given under ICTA 1988, s. 790 for overseas taxes 'computed by reference to income'[21] and not by reference to other indirect taxes. This might seem to justify the approach taken by the CFC legislation in restricting admissible overseas tax to tax paid on profits. However, that provision offers no suitable analogy in the present case due to the different function fulfilled by the test of 'lower level of taxation' in the context of the CFC rules. Whereas the double tax relief provision provides a mechanism by which foreign taxes on income already suffered may be credited against U.K. taxes arising on the same income, the determination of whether there is a lower level of taxation is a means of testing whether the company in question is located in a 'privileged tax regime' (to use the words adopted in the early Revenue consultative paper[22]). As such, it is appropriate that the overall tax burden be considered and not merely a portion of it. The failure to consider the total tax burden affecting an overseas CFC, irrespective of the nature of those taxes, is an example of a somewhat illiberal attitude on the part of the U.K. fisc.

An immediate danger of this attitude is that the overseas CFC may thereby be subject to a considerably higher level of taxation since it will be taxed under the U.K. CFC rules on the basis of its profits and it may also be taxed in its local overseas jurisdiction by taxes which are not linked to profits. The effect of this

may not be, as is claimed by the Revenue, to remove the tax advantages of operating overseas, but may be to create a positive discouragement to the operation of certain overseas subsidiaries.

A further difficulty with the lower level of taxation concept is its apparent inequity. The legislation requires a comparison to be made between the tax charged on a CFC in its country of residence and a notional U.K. tax charge computed on the hypothesis that the CFC is resident in the U.K. and not entitled to double tax relief for any tax paid in the country of residence of the CFC.[23] Allowances for foreign tax paid in respect of activities outside the country of residence of the CFC are available in respect of the computation of hypothetical U.K. tax but not in respect of the tax charged in the CFC's country of residence.[24] This means that if a CFC is resident in country A and pays tax of £25,000 and has a branch operation in country B on which it pays tax of £200,000, the local tax to be taken into account for the purposes of determining whether it is subject to a lower level of taxation is the amount of £25,000. For this purpose, the £200,000 tax suffered on the branch activity is completely ignored. A more appropriate comparison would be to consider the total tax borne by the CFC as against the U.K. tax that would be borne had the company been U.K. resident. The effect of this legislative approach is, according to the Law Society's Standing Committee on Revenue Law:

> '... so far from being confined to cases of substantial tax avoidance, the legislation was capable of being applied to recover U.K. tax at a rate of less than 1 per cent.'[25]

One commentator justifies this approach, giving the rationale for it as follows:

> 'Disregarding foreign taxes paid to third countries is not unreasonable because taking them into account makes the definition of a tax haven too susceptible to manipulation by taxpayers. Tax haven activities could be sheltered rather easily by

> establishing a branch in a high tax country so that the total foreign taxes are equal to or in excess of the required percentage of the domestic tax'[26]

Even disregarding the practical tax and commercial difficulties that would arise as a result of the 'manipulation' strategy suggested above, and assuming that the fisc would not otherwise be able to attack such a manoeuvre, it would remain the case that the foreign taxes paid would, as a result of the suggested strategy, equal or exceed the required percentage of domestic tax. In such a case it is therefore difficult to see why such an arrangement is to be deliberately precluded, since the legislative requirements would have been met by the taxpayer. Certainly, if this is the sole reason for the way the U.K. legislation has been framed, it is highly doubtful if the resultant 'advantage' to the fisc is justified in comparison with the inequity caused to the taxpaying community.

U.K. CFC PROVISIONS AND NEUTRALITY

Genuine Business Activities

One of the clearest themes of the Inland Revenue documents is the statement that genuine business activities will not be prejudiced by the CFC legislation. The first consultative paper of January 1981 states that:

> 'In order to maintain the free movement of capital, the scheme is designed to provide full and effective safeguards for genuine trading and commercial activity.[27]

As the above quotation implies, the reason for not prejudicing 'genuine trading and commercial activity' is rooted more in economics than in any perception of fiscal equity. In December 1982 it is stated that the U.K. Government 'fully recognise the importance of preserving the international competitiveness of U.K. enterprises and the position of London as a financial centre'.[28]

In the December 1981 document emphasis is again given to the view that the proposals 'should in no way impair the international competitiveness of United Kingdom companies trading abroad'.[29] In the next paper in the series, the discussion of the exemption for genuine business activities again features prominently. This prominence is underlined by the statement by John Wakeham MP, Minister of State, Treasury, in December 1982, that 'we are determined that legislation to counteract avoidance should not in any way be damaging to genuine business activities'.[30] Such 'genuine business activities' may qualify for exemption from the charge by either the exempt activities test or by the (theoretically broader) motive test. Both are discussed below, starting with the motive test.

The Motive Test

The importance of the exemption accorded by the motive test is emphasised by the Revenue's acknowledgement that, although there are available certain specific statutory exclusions (at the time of the consultative document, two such exclusions were proposed), the motive test would be of much wider significance as a means of exempting a company from the charge:

> 'However, neither of these statutory exclusions is intended to be comprehensive; it is recognised that many companies could only avoid a charge by satisfying a motive test'.[31]

Indeed, a much more forceful statement is made in the December 1982 document:

> 'The proposed tax charge would apply only where a main purpose behind the arrangements was deliberately to obtain a significant reduction in U.K. tax'.[32] (emphasis added)

The Revenue in fact justified the relatively restrictive exemptions available under the acceptable distribution test and the exempt activities test (the public quotation

exemption was added later in the consultative process) by the availability of the motive test.

In view of all the preceding comments it is somewhat surprising to find that the motive test which was finally enacted is most unlikely to fulfil the function so clearly assigned to it. As has been noted in the last chapter, the test is in two parts, both of which must be met in order to avoid a direction.[33] The first stage looks at the individual transactions of a CFC; the second stage at the reason for existence of the company.

Under the first stage, no direction shall be given if any of the transactions of a CFC (either alone or combined) achieved a reduction in U.K. tax for anyone but the reduction was either minimal or it was not one of the main purposes of the transaction (or transactions) to achieve such a reduction. A transaction is stated to achieve a reduction in U.K. tax if 'any person' would otherwise have paid more tax or be entitled to a lesser tax relief.[34] This over-broad statutory definition therefore means the reduction is not restricted to the CFC's parent or other group company. It would also appear that the Revenue take the view that the reduction need not arise solely due to the existence of the CFC and thus, for example, in the view of the U.K. fisc, a reduction takes place if a premium is paid to a captive insurance company even if the same payment would otherwise have been made to an unrelated insurance company.[35] These factors make the satisfaction of the first limb of the test rather more difficult than would appear from the phrasing of the test itself.

Even if this first test is satisfied, the second test must also be satisfied. Thus, it must also be the case that it was not one of the main reasons for the company's existence in the relevant accounting period to achieve a reduction in U.K. tax by a diversion of profits from the U.K.

Whether such a reduction by means of diversion is achieved is determined in accordance with the provisions of ICTA 1988, Schedule 25, para 19. These

provisions state that such a reduction is achieved if it is 'reasonable to suppose' that, had neither the CFC nor any related company existed, a substantial part of the receipts reflected in the profits of the CFC would have been received by a company or individual resident in the U.K. and therefore subject to U.K. taxation.

The supposition that the CFC does not exist for the purposes of determining whether there has been a diversion of profits from the U.K. seems prima facie a reasonable approach. However, the extension of this supposition to 'any related company' is more questionable, particularly insofar as the legislation is applied in practice by the Revenue. A 'related company' is defined to be a non-U.K. resident company which is connected or associated with the CFC and which fulfils, or could fulfil the same functions as the CFC.[36] The Revenue interpret the phrase 'fulfils or could fulfil' in the widest possible sense to include any related company which theoretically could carry on the CFC's functions (i.e. not being prevented by local legal reasons from so doing) regardless of the normal activities of that related company. The effect is that entire overseas sub-groups or regional groups which may be quite autonomous and separate to the CFC are deemed not to exist for the purpose of the second limb of the motive test. This obviously makes the second limb of the motive test more difficult to satisfy.

The rather fanciful hypothesis in the second limb of the motive test is apparently designed to test whether the diversion is the reason for the existence of the CFC. However, the test is so open-ended and imprecise that its significance inevitably depends on how it is interpreted by the Inland Revenue.

On the hypothesis that neither the CFC nor any related company existed, it is probably 'reasonable' to suppose that the business activity carried on by the CFC would be conducted by the parent company, probably through a branch located in the country in which the CFC is located. The existence of the CFC is therefore in virtually all cases likely to lead to an effective diversion of profits from a

company resident in the U.K. Therefore, on any strict view it will in almost all cases be theoretically impossible to satisfy the motive test.

In view of the emphasis placed on the importance of the motive test during the consultative process this potential lack of protection from a direction disturbed a number of those responding to the Revenue papers:

> 'We believe that this whole chapter [CFC proposals] puts excessive reliance upon the motive test, which cannot be a satisfactory substitute for proper legislative recognition of the complex realities of international business. Experience has shown that anti-avoidance legislation of this kind (and the motive test in particular) is over a period of time - in spite of assurances given by government ministers when introducing the legislation - almost always interpreted to the detriment of the tax payer....[37]

Practice has borne out these fears and it is generally perceived that the Revenue is taking a relatively strict view on the use of the motive test. For example, it is known that the Inland Revenue has issued standing instructions to its Inspectors of Taxes to refer to the specialist Technical Division any CFC case where reliance is placed on the motive test by the taxpayer.[38] Whilst such a policy gives the Inland Revenue an opportunity to apply the test with a consistency of standard, it is perhaps to be regretted that in practice it appears that a very significant amount of evidence is required before the Revenue are prepared to contemplate the application of that test.[39] The motive test is therefore by no means the broad exemption that appears to have been envisaged in the consultative process. Instead, it is applied restrictively and therefore available in relatively few cases only. Indeed, it is arguable one of the worst failings of the CFC legislation that, notwithstanding the official statements made about the use of the motive test in the course of the consultative process, the following is unfortunately a fair reflection of the test from the perspective of the tax practitioner:

> 'Practitioners therefore tend not to regard the motive test as having equal status with the other tests for exemption, and regard it rather as something to fall back on as a last resort when all else fails. The language of the distribution and exempt activities tests although complex, is at least relatively straightforward in its intent. The motive test, by contrast, is so obscure that professional advisers often feel they cannot recommend their clients to rely on it.'[40]

Exempt Activities

The other means by which companies carrying on what the Revenue perceives as 'genuine business activities' may be protected from the CFC legislation is by carrying on 'exempt activities'.[41] On the Revenue's own admission this is not a comprehensive test, chiefly on the grounds of the difficulty of drafting such a comprehensive clause and the availability of the motive test.

In general, certain business activities of an overseas business establishment will be exempt subject to a number of conditions. The most significant requirement is that such activities should not be certain specified activities (including, for example, dealing in securities other than as a broker and leasing business).[42] The grounds for the exclusion in the case of leasing activities are explained by the fisc as follows:

> 'We recognise that bona fide leasing is often done through overseas subsidiaries for good commercial reasons. But there is also considerable scope for avoidance of U.K. tax in this area. It would be extremely difficult to draft a satisfactory statutory provision which distinguished these cases, except by means of a motive test'.[43]

The exempt activities test was initially called the 'genuine trading test'[44] but later changed to the 'exempt activities test'. The change was made to avoid any

implication that a company which fails to satisfy this test is in some way not engaged in 'genuine' activities.[45]

The test attracted much comment by way of public response during the consultative process but, according to the Revenue:

> 'Much of this appeared to be based on a misunderstanding of its purpose, which was simply to exclude from the charge companies whose activities were not of the kind used to avoid U.K. tax. Thus although much leasing business is 'genuine', an overseas leasing subsidiary may lend itself to use as a vehicle for avoiding U.K. tax; and so leasing as such is not appropriate for general exclusion through the test'.[46]

The test is therefore more appropriately understood as an exemption for certain selected trading companies. If the test were designed to stand by itself as a comprehensive test this discrimination would be particularly inequitable. However, the (presumed) intention that this test will quickly exclude all those companies carrying on business which the Revenue do not wish to bring within the charge, leaving the motive test to sort out the remainder, is a reasonable approach. Unfortunately, as a result of the analysis of that latter test, it is unlikely that the motive test can be relied upon to do this.

Effect on Business Activities

In 1982 it was stated that the Government 'do not believe that anything in their present proposals would damage U.K. business generally, nor should it deter multinationals from using the U.K. as a base'.[47] However, despite the official concern with the importance of preserving a neutral effect on 'genuine business activity', there remain doubts, as a result of the framing of the motive test and the exempt activities test, together with the subsequent relatively restrictive Revenue

approach to the motive test in practice, whether this objective has been achieved. There are a number of reasons which substantiate these doubts.

Unlike Subpart F (which will always apply in certain specified cases), the legislation is not certain in its application and there will therefore be some uncertainty whether the CFC provisions will affect a particular company.[48] The uncertainty arises not merely for the reasons already discussed but also, inter alia, for the degree of discretion afforded to the Revenue, a matter which is discussed later in this chapter. The lack of certainty of application of the legislation therefore constitutes a ground for fear that the legislation may affect 'genuine' business activities.

A second concern is the information powers given to the Revenue under this legislation. The Revenue are empowered to enquire into who owns the CFC; what their respective interests are; what associates the CFC has; how much overseas taxes it bears; and the nature of its activities and income.[49] On this matter the Institute for Fiscal Studies working party commented:

> 'Very wide information gathering powers are given to the Revenue in the draft legislation. This information could concern the customers of a CFC and have damaging commercial consequences, particularly in the case of overseas banks'.[50]

Third, regardless of what actually does happen under the CFC legislation, the perceptions of the way the legislation operates (both currently and in the future) are also relevant. The provisions clearly have an 'in terrorem' effect[51] but, in view of the concerns already mentioned, this effect may deter a wide spectrum of activities, including some the fisc appear not to wish to deter.[52]

It is obviously impossible in the space available to survey in any detail the impact of the CFC legislation on legitimate business activity. However, taking the captive insurance sector as an example, one or two comments may be made as to the

Revenue attitude to the application of the legislation and its likely impact in general.

It is clear that captive insurance companies themselves are a target of the Revenue in applying the CFC legislation. This arises from the fact that offshore captive insurance companies were cited by the Revenue in the course of the consultative process as representing clear abuse of the U.K. taxation system.[53] The fact that captive insurance companies are regarded simply as means of offshore tax avoidance suggests an unsophisticated commercial awareness on the part of the Inland Revenue. In the majority of cases, such companies represent a means by which arrangements relating to a group's insurance could be improved and made more efficient with an additional saving in costs. Non-fiscal U.K. and E.E.C. legislation is largely responsible for the fact that such companies have not been established in Europe. Since these companies are effectively on the Revenue 'hit list', it is probably correct to say that, as a result of the CFC legislation;

> 'the ability of the captive to accumulate funds which would then enable it to retain a larger proportion of the group's risks without the need for extensive reinsurance will have been seriously curtailed'[54]

Assuming that the CFC provisions apply to an offshore captive, it will be necessary to see if any of the exemptions are available to prevent a direction from arising.

A captive insurance company is unlikely to be able to satisfy the exempt activities test because one of the requirements for that exemption to operate is, broadly, that most of the business of the company in question must be with non-connected parties.[55] Captives could possibly try to fall within the exemption by entering into arrangements with other (unrelated) captives so as to bring their gross receipts

from connected parties down below 50% of gross income but this arrangement is likely to prove administratively cumbersome and may be expensive to operate.

Enough has already been said on the motive test for it to be reasonably clear that exemption is no panacea in the case of the offshore captive. Difficulties would be particularly acute in the case of the second limb of the motive test: given the attitude of the Revenue to captive insurance companies it will be a difficult task to show that the choice to locate the captive offshore (in a country probably regarded by the Revenue as a tax haven) was not motivated to achieve a reduction in U.K. tax by a diversion of profits from the U.K. This means that, if challenged, an overseas captive subsidiary would be able to avoid a direction under the CFC legislation only if it pursues an acceptable distribution policy. The Revenue have in practice been extremely reluctant to accept that a captive insurance company can be a trading company and would therefore require a distribution of 90% of available profits rather than the 50% which applies in the case of trading companies. The difficulties of persuading the Revenue that a captive can be a trading company stem largely from the fact that, as noted above, the Revenue appear to have decided already that the use of such companies amounts to an abuse of the U.K. taxation system.[56]

A consequence generally of the above discussion on captive insurance companies, is that the CFC legislation is likely to be applied in many cases against captives, thereby reducing significantly the extent to which such companies can be used by U.K. based multinationals. It is therefore difficult to resist the conclusion that the U.K. CFC legislation does have an important (and adverse) effect on business activities and is non-neutral in its effect.

However, it may be argued against the above conclusion that captive insurance business is in any event not a legitimate business activity and, further, that the CFC legislation actually maintains neutrality as between U.K.-based and tax-haven based captive insurance companies established by U.K. multinationals. It is considered by the author that these objections are misconceived.

If captive insurance business were not deemed a legitimate business activity then it would be necessary to explain why - and by what criteria - this conclusion has been drawn. Similarly, if CFC legislation is justified by reference to the need to preserve neutrality between, for example, U.K.-based and tax-haven based captive insurance companies established by U.K. multinationals, it would be necessary to explain the reasoning behind the apparent extension of the neutrality principle to the proposition (which is implicit in such a view) that the fisc of one state should tax not only its own residents but those of other states on an equal footing.

These questions lead to a number of difficulties which are taken up in the two concluding chapters of this thesis.

U.K. CFC PROVISIONS AND OTHER ISSUES RELATING TO IFL

Acceptable Distributions

In considering the acceptable distribution exemption, the principal concern is with its artificiality. Given the extremely high level of distribution required (50% for a trading company, 90% for other companies) it is impossible to regard the exemption as based on an approximation of good business practice. There will perhaps be some companies in respect of which a 50% dividend is acceptable but in general the level of dividend declared by any company will depend upon a relatively large number of factors such as the type of company; current and proposed activities; capital expenditure planned; company law relating to distributable profits; level of gearing, etc. The absolute percentage requirements should therefore be tempered with a reasonableness test so that surrounding circumstances could also be considered and the level of required distribution reduced as necessary.

In enacting the CFC provisions, the fisc is seeking to attack the 'special arrangements, in which normal commercial activities are distorted largely for tax reasons'.[57] The stated aim is not to prevent the use of what they perceive as tax

havens but to remove the artificial fiscal incentives to U.K. companies of such use. (The Revenue notes say 'the proposals would not prevent these transactions but would merely ensure no tax advantage would accrue from them'[58]). The required percentage distributions are part of this strategy and, presumably, designed to put companies located in privileged tax jurisdictions in a position of parity with companies conducting 'normal commercial activities'. This is achieved by ensuring that a portion of the profits of the overseas company are remitted to the U.K. where they will be taxed.[59]

However, there is no clear rationale or explanation as to why the level of distribution varies according to whether or not the CFC is a trading company or not[60] and it certainly seems somewhat odd that the degree to which the perceived avoidance of tax is moderated by the acceptable distribution test depends on the status of the activities concerned, judged by reference to the U.K. trading-investment company distinction. If it is considered that any particular activities should be subject to the CFC legislation and an acceptable distribution test there would seem no reason in principle why the same level of acceptable distribution should not apply. The point is perhaps all the more significant where the activities concerned could, depending upon the precise arrangements, be characterised as trading or investment activities, as might be the case with regard to factoring activities.

By failing to take a more realistic view of what could constitute an acceptable distribution for the purposes of the legislation, the Revenue is effectively creating an artificial test which will in many cases have little in common with the levels of distribution that would otherwise exist. As such, by the requirements of this exemption, the Revenue will bring about precisely what they have declared themselves to be opposing, namely, 'special arrangements, in which normal commercial activities are distorted largely for tax reasons'.

There are a number of other more detailed problems associated with the operation of the acceptable distribution exemption and the mechanics of its operation but space does not permit further discussion of them here.[61]

Inland Revenue Discretion

Although the criteria which should be observed in promulgating CFC legislation are discussed in more detail in the next chapter, one issue properly discussed in this chapter is the degree of discretion accorded to the Revenue by the legislation.

In the U.K. there is a generally held view which opposes the existence of Revenue discretion, as a significant instrument of the tax law. This attitude is aptly summed up by Lord Wilberforce in the case of Vestey v. IRC:

> 'One should be taxed by law, and not untaxed by concession.'[62]

The Revenue view on the amount of discretion available to them under the legislation is stated as follows:

> 'There is widespread concern - almost all of it misconceived - about the extent to which the proposed legislation would operate at the 'discretion' of the Inland Revenue. The fact is that the only significant discretion granted to the Board would be in deciding whether or not to make a direction after consideration of all the circumstances. In all other respects the procedure to be followed in apportioning a tax liability among those having an interest in a controlled foreign company and raising the appropriate tax assessments would be specified in the legislation'.[63]

In the circumstances, the use of a de minimis threshold is to be welcomed, chiefly because the requirement for a direction to be made should eliminate a

considerable amount of work for both the Revenue and the taxpayer, although this potential benefit to the taxpayer may in some cases be lost due to the requirements of auditors that the potential effects of the legislation on U.K. companies be taken into account for the purposes of the computation of the tax provision contained in the company's statutory accounts.

The single item of discretion admitted by the Revenue is not unimportant in itself. It is certainly made of more significance by the impact of the relatively low de minimis threshold of £20,000 relating to chargeable profits. Where profits fall below this threshold, it will be remembered, no direction under the legislation will be made.[64] Due to the relatively low level of the threshold, it is likely that most, if not all, companies will not fall within the exemption.

There is therefore the danger that, due to the large number of cases potentially subject to the charge, the Revenue will have only sufficient resources to make directions in a proportion of those cases. This could lead to hostility to the legislation by the business community if it is perceived that similar cases could be treated differently simply as a result of the scarce manpower resources of the Revenue.[65] This difficulty could be avoided and demands on Revenue resources relieved by increasing the minimum threshold to something in the order of £100,000, below which figure it is quite possible the Revenue would not, in any event, seek to make a direction due to the relative insignificance of the chargeable profits involved. Other reasons for a significant increase in the de minimis figure have also been advanced in the commentaries on the Revenue consultative papers.[66]

Despite the above Revenue quotation, the discretion afforded to the Revenue would appear to go beyond the single instance cited.

For example, the legislation provides that:

> '... the Board may, if they think it appropriate, treat a loan creditor of a controlled foreign company as having an interest in the company for the purposes of this Chapter.'[67]

Similarly, discretion is granted to the Revenue in applying the motive test so that, for example, 'if it appears to the Board' that a reduction in U.K. tax is 'minimal' or 'not the main purpose or one of the main purposes' of a transaction, relief under the motive test will not thereby be denied.[68] Other instances could equally be cited.[69] Although there is a general right of appeal against these determinations made by the Revenue, it is clear that a fairly significant degree of latitude is granted to the Revenue in administering the CFC provisions.[70] This explains the statement made by a leading commentator:

> 'In many respects with this legislation - not least in the fact that it is to be applied or not at the Revenue's discretion - corporate taxpayers are, in effect, being asked to trust the Revenue to act reasonably and have good sense in using the legislation.[71]

Tax Havens

As is the case with Subpart F, the U.K. CFC provisions avoid specifically identifying the tax havens against which the measures are directed. In the U.K. this is achieved by the use of the concept 'lower level of taxation'[72], which was referred to earlier in the consultative process as 'privileged tax regime'.

The application of this concept in the legislation may involve both uncertainty and, in effect, retrospective taxation. This is because the determination of whether the CFC is located in a state with a lower level of taxation is made separately for each accounting period. Given the constant changes to tax codes made by most fiscs, it will often be difficult to say during any accounting period whether a lower level of taxation exists. As such the effect of the CFC legislation will be known in many

cases only after the end of an accounting period, thus possibly leading to effective retrospective taxation.

A further difficulty with the operation of the lower level of taxation concept is its inequity, both as regards the type of tax that is to be considered for the comparison between notional U.K. tax and tax actually borne in the state of the CFC and also as regards the exclusion of tax paid in states other than the CFC's country of residence. These points have been considered earlier in this chapter.

Notwithstanding the inclination away from listing states in which residence of U.K. CFCs will cause the legislation to apply, the Revenue has published a list of countries which are 'excluded'. The main features of this excluded countries list were mentioned in the last chapter.

Unfortunately, there is no official explanation of the specific basis on which the excluded countries list has been drafted. The official Press Release introducing the list merely states that:

> 'The purpose of the list of excluded countries is to give an assurance that a charge will not arise under the controlled foreign company legislation in respect of companies in countries named on the list. Where a company is resident and carrying on business in a listed country, it will be regarded as meeting the conditions for exclusion set out in the legislation itself'[73]

Presumably, the assumption made by the fisc is that by locating in a relatively high-tax country (and satisfying the requirement of deriving 90% of its income locally) a company would not have a tax-avoidance motive and may therefore be deemed to have satisfied the motive test of ICTA 1988, s. 748(3). The assumption would in fact appear to be that companies established in the states on Part I of the excluded countries list are <u>never</u> used for the purposes targeted by the U.K. CFC rules because of the relatively high tax rates generally prevailing in those

states. This assumption is to some degree inconsistent in principle with regard to the approach adopted in the case of those companies in states which are not featured on the excluded countries list and which are subject to the legislation: Such companies are considered in terms of the effective rate of overseas taxation to which they are subject. There is, however, some attempt at ensuring that a relatively high effective rate of tax will apply to companies in states on Part I of the list. This is provided by the requirement that 90% of their income is derived locally. Nonetheless, this split approach may appear somewhat inequitable, particularly in contrast to the more even-handed approach of the Subpart F provisions.

The possible inequity of the U.K. approach lies in the fact that the Inland Revenue's evaluation of a state's fiscal system will have such a significant impact on how companies in that state are affected by the legislation: if the state is not so listed, a company will be in the quite different position of having to analyse its effective rate of local taxation and complying generally with the CFC measures, a burden which is not insignificant:

> 'The burden on taxpayers in complying with anti-tax haven measures can be extremely onerous. Financial books and records must be kept, usually on the basis of domestic tax law; amounts must be translated from foreign currency into domestic currency; tax returns must be filed. Whenever two countries' tax systems are involved, compliance difficulties are inevitable. The principles of financial accounting and tax law invariably differ considerably from country to country. Accountants and employees of the controlled foreign corporation will rarely be familiar with the tax law of the country of residence and similarly the controlling shareholders' professional advisers will rarely be familiar with the foreign tax law. Misunderstandings are inevitable. The cost of professional advice is not insignificant. Language differences often compound the difficulties.'[74]

It would clearly be quite incorrect to suggest that the excluded countries list as a whole has been prepared arbitrarily since the Inland Revenue has obviously devoted significant internal resources to its preparation. However, the fact that, for example, Venezuela appears on Part I of the U.K. list yet is black-listed as a tax haven by France, Germany and Japan,[75] does raise certain questions as to whether the U.K. Revenue have the necessary resources to devote to updating the list and ensuring its continued fairness.[76]

The Revenue has stated that the protection of the list of excluded countries effectively provides an automatic exclusion from the charge in respect of an estimated 90 per cent of all the overseas subsidiaries of British companies'.[77]

Nonetheless, there is no statutory basis for this exemption and it can only apply if the various conditions are met (in the case of states listed on Part I of the list the CFC must be resident in the country under the terms of the definition of residence given in ICTA 1988 s. 749(1) and 90% of the company's 'commercially quantified income' must be derived from that country).

These two apparently straightforward conditions cause a number of practical difficulties. A CFC will be deemed to have satisfied the first condition if it is taxed in the overseas state under local law by reason of its 'residence, domicile or place of management'.[78] Alternatively, where a state does not use any of the above criteria, incorporation is the test used. Unfortunately, this approach does not cover all situations. For example, if a non-resident U.K. company is used to carry on a business in a foreign state where incorporation is the criterion of residence (e.g. Denmark) it seems impossible for that company strictly to satisfy the requirement of the list since its income is not taxed in Denmark by any of the above-mentioned four criteria, even though 100% of its income may be taxed in Denmark.

With regard to the second condition, a company is regarded as carrying on a business in a country (and therefore as having met the condition) if 90% of its commercially quantified income is 'local source income', which means income

which is treated under a country's own laws as 'accruing in, arising in or being derived from that country and which is within its charge to tax'.[79] This means that the list can be operated only by a close scrutiny of the overseas state's approach to taxation. This approach is perfectly acceptable where the overseas state has simple or well-defined source rules. However, where a state has very complex source rules under which there may be genuine areas of difficulty (such as the U.S.[80]) the approach of the U.K. excluded countries list becomes inherently problematic. In practice, the Revenue's approach in policing this requirement is to ensure that income, which would be taxable under Case V of schedule D if the company receiving it were resident in the U.K., is excluded. This approach to the operation of the requirement assumes that the overseas state has a rule or concept similar in nature to that embodied in Case V of Schedule D but this may not necessarily be the case, in which case it may be difficult for this second condition to operate.[81]

The fact that the list has been drawn up by the Revenue and not incorporated into statute is a further example of the discretion afforded to the Revenue in this area of the law. If the Revenue view that 90% of British companies will be removed from the charge by reason of the list is correct, then the amendments made to the list will be of considerable practical significance. As such, the effective decision to tax or not to tax should be assigned to Parliament and not delegated to the Revenue. Further, since the list has no statutory force there will be no right of appeal open to a taxpayer if the Revenue seeks to apply the CFC legislation to a company resident in a country located on the list. For these reasons, the list should have some form of statutory basis.

Impact on Use of Tax Havens

One consequence of the way in which the U.K. CFC legislation is formed is that it is likely to affect the actual 'tax haven' states used by U.K. multinational groups. In view of the lower level of taxation concept, such states are now more likely to be used where profits will be taxed at a rate equal to or in excess of 50% of the

U.K. tax that would be payable if the profits were subject to U.K. tax. Thus, a company resident in Jersey will generally be an attractive option because the Jersey 20% tax rate will (assuming a similar computation of taxable profits in both Jersey and the U.K.), prevent the U.K. CFC legislation from having any application[82], thus allowing tax deferral in Jersey of 15% of the annual profits arising. The stimulus to the use of Jersey resident companies as a result of the U.K. CFC provisions may be contrasted to a state in which there is an opposite effect. Hong Kong, for example, will not represent an attractive location because a company established there cannot ever be outside the scope of the CFC legislation, regardless of whether or not the effective rate of local tax exceeds 50% of the corresponding notional U.K. tax.[83] This is because of the presumption that a company which is not liable to tax in any country by reason of domicile, residence or place of management is to be conclusively presumed to be a CFC subject to the U.K. legislation.[84] Since Hong Kong taxes on a territorial basis, a Hong Kong company will inevitably be subject to the CFC legislation. Whatever the impact of the CFC legislation on 'genuine business activities', it seems clear that the legislation has a non-neutral effect on the use of overseas states by U.K.-based multinationals.

The Anti-Tax Haven Initiative

Before leaving the subject of tax havens, one further comment on the U.K. CFC measures should be made.

Although there are no official comments on the immediate targets of the CFC legislation, a widely-held view amongst tax practitioners was that one of the primary reasons why the measures were being introduced was to stop the extensive use by U.K. companies of subsidiaries located in Jersey and Guernsey, where a 20% rate of tax applies to income tax companies. Ironically, this intention was partially frustrated by a measure introduced by the same Finance Act which enacted the CFC provisions. In 1984, Chancellor Lawson announced a reduction in the rate of corporation tax from 52% to 35%.[85] The effect of this

is that most types of Jersey and Guernsey income tax companies will now not be subject to the CFC provisions as companies established in those locations will not be subject to a 'lower level of taxation' for the purposes of the U.K. CFC legislation (because the amount of tax paid in Jersey or Guernsey will not be less than half of the tax which would have been paid had the company been resident in the U.K.). Of course, this point applies only in respect of income tax companies and not the tax-privileged corporation tax companies which are taxed on a flat-fee basis.[86] However, the point does lend credence to the view that the CFC provisions in reality represent the culmination of an initiative undertaken in a quite different economic and fiscal climate to that in which they are applied. When the measures were first proposed the U.K. tax rate of 52% represented one of the highest corporation tax rates in Europe : now that the measures have been enacted the U.K. corporation tax rate of 35%[87] is amongst the lowest in Europe and, as has been mentioned earlier, the U.K. is being acclaimed as a leading tax haven. Somewhat unfortunately perhaps, these points have not in any way affected the statutory form of the legislation, nor the way it has been applied by the Inland Revenue.

Complexity of the Legislation

Comments on the Inland Revenue's application of the CFC legislation made earlier in this chapter may suggest an over-partisan approach on behalf of the fisc toward the use and interpretation of this legislation. Whilst in many instances such an observation seems accurate, it is also necessary to consider the circumstances in which the fisc must apply the legislation. The CFC legislation is relatively new and, certainly, relatively complex.

The Revenue is therefore seeking to ensure a uniformity of interpretation, a task made necessary because, notwithstanding the long drafting and consultative process, ambiguities and unforeseen interpretations have emerged since the enactment of the measures in 1984.[88] In view of the above, the Revenue generally appears to be relatively wary of accepting arguments or giving concessions which

might undermine the purpose of the legislation. In consequence, a defensive and unbending attitude on the part of the fisc tends to be experienced in problem cases.[89]

To some extent, this is a difficulty which arises as an inevitable result of the complexity of the legislation; the more complex the legislation, the more likely it is that these difficulties will be made inevitable. The position with regard to the CFC legislation can be compared to the U.K. legislation on transfer pricing. The latter is simple, both conceptually and in its legislative form, which makes its operation and interpretation relatively straightforward. This suggests that there may be inherent problems with complex legislation, a suggestion which, it is submitted, finds substantial corroboration in the preceding discussion and in the discussion of the detailed Subpart F legislation. This factor of complexity is not recognised in either the U.S. or U.K. official discussions of the respective CFC legislation and it is therefore not possible to consider what account of it, if any, is taken by the fisc.[90]

The above points on the complexity of the legislation are obviously relevant to the U.S. CFC legislation as well as to the U.K. measures and they are therefore considered in more detail in the next chapter, which is concerned with an evaluation of unilateral anti-tax haven legislation from the perspective of the policies and principles of international fiscal law (based on the U.S. and U.K. discussions) on a more general basis.

CONCLUSION

As with the earlier material on Subpart F, conclusions on the key elements applying in common to the CFC legislation of the U.S. and the U.K. are discussed in the final two chapters of this thesis. However, certain 'localised' conclusions on the U.K. CFC legislation may be made at this stage.

Whereas the discussion of Subpart F was able to consider the policy changes to that legislation since its enactment in 1962, the discussion in this part of the thesis has, in recognition of the relatively short time the U.K. legislation has been in force, been more concerned with the consultative process preceding the enactment of the U.K. legislation. The discussion of that consultative process has highlighted the rather poor discussion of the issues by both the Inland Revenue and, with certain exceptions, by the representatives of the taxpaying community. With regard to the contribution made by the Inland Revenue, the case for the need for the measures was hardly conclusive, with virtually no proper analysis of the issues and no supporting economic data. Such 'empirical evidence' as there was (i.e. the Inland Revenue survey) was introduced late in the consultative process and cannot in any event be interpreted as amounting to much more than a gesture in response to the calls for proper evidence of abuse. The contribution from taxpayers and their representatives was, generally, not a conspicuous success. With one or two notable exceptions[91] there was very little recognition of the fundamental issues nor of their significance to the debate. Instead, the majority of the respondents seemed to confine themselves to making representations on the more detailed points of the (then) proposed legislation, although it is perhaps worth noting that these responses were generally of a relatively high standard if judged on their own terms.

It is submitted that, in all circumstances, the poor quality of the consultative process is fundamental to any appraisal of either it or the legislation it produced and therefore certainly not a matter of merely academic concern. In the present context the immediate concern arising from the pool quality of the consultative process is that various matters which are of fundamental importance from the perspective of IFL (and, in particular, by reference to the primary objective underlying IFL and the policies and principles of IFL) were given insufficient consideration or were completely ignored.

The final and concluding part of this thesis explores in further detail why a proper analysis is required of these matters and also draws certain conclusions on the

issues discussed in this chapter. The conclusion indicates the fundamental issues which should be addressed prior to the enactment of CFC legislation and also offers certain conclusions on the consequences for IFL, and the development of IFL, which are likely to result from a failure to give those issues the attention they merit.

CHAPTER 7 - NOTES

1 Admittedly, the organisation of the material between chapters Five, Seven and Eight may make a clear perspective on the earlier material more difficult. However, conclusions on the major issues from the perspective of IFL which are common to both the U.S. and the U.K. material are deliberately postponed to Chapter Eight where they may be considered in the light of the more detailed and separate discussion of the U.S. and U.K. provisions.

2 The Institute of Directors took a quite different view and restricted itself in the early stages of the consultative process to replying in terms of the general principles of the proposed legislation. The Revenue appears not to have responded to this approach and it is left to another commentator, the Institute for Fiscal Studies, to reply to the effect that, in the limited context of the purpose set out for the legislation by the Revenue, the extension of the U.K.'s tax base is justified. However, even in this reply, there is no detailed discussion or reasons advanced to justify the extension of the U.K. tax base (see Institute for Fiscal Studies, 'Report to the Working Party on Company Residence, Tax Havens and Upstream Loans', IFS Report Series No. 3).

3 The reasons for this concentration on detail and the ignoring of certain more fundamental matters of principle are not immediately obvious. Primarily responsible is probably an attitude of narrow self interest on the part of many of the parties which responded to the Revenue's consultative papers.

4 Comments submitted by the Accepting Houses Committee/Issuing Houses Association in February and March 1982 to the Inland Revenue. See 35 Taxes International, September 1982, p. 14. These representations are published in 35 Taxes International, September 1982, p. 14.

5 Note 30, Ibid, foreword by John Wakeham, M.P.

6 Note 30, Ibid, pp. 22-23.

7 The point is arguably all the more important because of Inland Revenue practice in connection with TCGA 1992, s. 13 formerly CGTA 1979, s. 15. S. 13 operates to attribute gains of non-resident but broadly closely held companies to U.K. persons holding shares in such companies on a pro-rata basis. In practice, the Revenue appear to accept that s. 13 cannot apply if its provisions are overridden by an applicable double tax agreement.

8 ICTA 1988, s.756(3) amending ICTA 1988, s.416(6).

9 ICTA 1988, s.416(2).

10 ICTA 1988, s.416(2).

11 Under the close companies legislation a person is taken to control a company if he exercises, or is able to exercise or acquire (now or as of right in the future), control over the company's affairs (ICTA 1988, s.416(2)). The phrase 'control over the company's affairs' is not defined and although certain instances of control are given by statute, these instances are stated not to detract from the generality of the concept of control, making the precise meaning of control impossible to ascertain.

12 ICTA 1988, s.747(5).

13 Note 31, Ibid, paragraph 9.

14 ICTA 1988, s.790(6).

15 See for example, the U.K. Statement of Standard Accounting Practice No.1, Accounting for Associated Companies, paras 14 and 15.

16 See 35 Taxes International, September 1982, p.15.

17 Note 31, Ibid, paragraph 9.

18 Note 30, Ibid, pp.29-30.

19 Institute of Directors, Submission on Inland Revenue Consultative Document of January 1981, p.8, paragraph 20.

20 ICTA 1988, s.750(1).

21 ICTA 1988, s.790(3).

22 Note 29, Ibid, p.ll.

23 ICTA 1988, s.750(2)(3).

24 ICTA 1988, s.750(1).

25 The Law Society, Memorandum by the Society's Standing Committee on Revenue Law, 'Taxation of International Business', February 1984, p.3.

26 B.J. Arnold 'The Taxation of Controlled Foreign Corporations : Defining and Designating Tax Havens - I' British Tax Review, 1985, p.286 at 298

27 Board of Inland Revenue, 'Tax Havens and the Corporate Sector', January 1981, p.2, para 4.

28 Note 30. Ibid, p.8.

29 Board of Inland Revenue, 'International Tax Avoidance', December 1981, p.lO.

30 Board of Inland Revenue, 'Taxation of International Business', December 1982, Foreword.

31 Board of Inland Revenue, 'Tax Havens and the Corporate Sector', June 1982, p.l.

32 Note 30. Ibid, p.8.

33 ICTA 1988, s.748(3).

34 ICTA 1988, Schedule 25, para 17.

35 This point has been experienced in practice by the author, and is also referred to by D. Ross; 'Anti-Tax-Haven Legislation - Three Years' U.K. Experience' Tax Planning International Review, February 1988, p.13.

36 ICTA 1988, schedule 25, para 19(2).

37 Note 4, Ibid.

38 This has been confirmed to the author in the course of practical dealings with the Inland Revenue.

39 This is to be regretted for two reasons. First, it increases the overall compliance cost to the taxpayer. Second, it creates considerable uncertainty as to the application in practice of the legislation.

40 D. Ross, 'Anti-Tax-Haven Legislation - Three Years' U.K. Experience' Tax Planning International Review, February 1988, p.13.

41 ICTA 1988, s.748(1)(b).

42 ICTA 1988, schedule 25, paragraphs 6 and 9.

43 Note 31, Ibid, section entitled 'Banks', paragraph 4.

44 See, for example, note 29, Ibid, at p. 11

45 Note 30, Ibid, page 24, paragraph 41.

46 Note 30 Ibid, page 24, paragraph 40.

47 Note 30, Ibid, p. 8.

48 The Consultative Committee of Accountancy Bodies commented on the proposed legislation: 'The proposals are of such potentially wide application that they will inevitably impact on much legitimate commercial activity and the complexity of the provisions will create an uncertainty and heavy burden of compliance.' (from public comments submitted to the U.K. Inland Revenue in March 1982, quoted in 35 Taxes International, September 1982, p. 17).

49 See generally, for example, ICTA 1988, s. 755.

50 Institute for Fiscal Studies, 'Report of the Working Party on Company Residence, Tax Havens and Upstream Loans', IFS Report Series No. 3, p. 26.

51 In the author's own experience in advising in this area, for example, it is noticeable that some taxpayers are concerned to avoid any possible application of U.K. CFC legislation whilst in other cases the vagaries of the legislation combined with the expected hostile approach of the Inland Revenue in applying the legislation make it extremely difficult to know precisely how the CFC legislation should be applied. In practice, this uncertainty will often render any particular proposal unviable.

52 For example, it is not clear whether factoring is in all cases outside the scope of the definition of 'investment business' for the purposes of the exempt activities test and therefore whether factoring activities may constitute exempt activities (see further ICTA 1988, Sch. 25 para.s 6 and 9). In fact, there are various forms of factoring, some of which are economically similar to funding or investment (on which latter point, see ICTA 1988, Sch. 25 para. 9(1)(d)). It is not known whether the fisc wishes to deter factoring activities conducted in subsidiaries of U.K. resident parent companies.

53 Five categories of such companies were cited in the Revenue paper. See Board of Inland Revenue; 'Taxation of International Business', December 1982, p. 12.

54 M. Finney; 'Impact of CFC rules on Captive Insurance', The Accountant, 3 February 1986, p. 26.

55 ICTA 1988, schedule 25, para. 6(2).

56 Note 53, Ibid.

57 Note 30, Ibid, p.7.

58 Note 31. Ibid, para 4.

59 However, even this simple objective may easily be circumvented by ensuring the 'acceptable distribution' made to the U.K. parent is routed through an intermediate 'mixing' vehicle so that on being remitted finally to the U.K. no U.K. tax is payable.

60 ICTA 1988, Sch. 25 para 2(1)(d) and (2).

61 For example, a company may be precluded from making a distribution under local company law provisions owing to the fact it has an opening debit balance on its profit and loss account and therefore has no legally distributable profits, notwithstanding profits have arisen in the year. Further where an acceptable distribution is made via a holding company which also receives income from another source and which makes a payment to yet another source, it is not clear what rules will apply for tracing the movement of cash and thus for determining whether the acceptable distribution test has been met. This problem is exacerbated where a CFC pays a dividend in order to satisfy the acceptable distribution test and the dividend is routed via a Dutch 'mixer' company. To ensure the dividend reaches the U.K. the Dutch company may find it necessary to specify that part of its dividend to the U.K. comes from the CFC. In consequence, there may then be problems in maintaining the 'mixer' function of that Dutch company as the Inland Revenue appear unwilling to accept, in the light of such a specification, that the underlying tax relating to the dividend from the CFC can be mixed with the underlying tax on other dividends received by the Dutch company from other subsidiaries.

62 Vestey v. IRC [1980] STC 10 at p.19.

63 Note 31, Ibid, paragraph 26.

64 ICTA 1988, s.748(1)(d).

65 This point also raises questions of equity, which was defined in Chapter 1, following the analysis by Adam Smith in 'The Wealth of Nations', as fairness between the body of taxpayers. It would be expected that those in equal circumstances should pay an equal amount of tax or, in this context, be subject to the CFC rules equally. On the relevance of equity in this sense - 'horizontal equity' - see further J A Kay and M A King, 'The British Tax System, (2nd edition,

1980 at pp. 203-204). It should also be noted that it is not considered that the discussion in the text on the scarce resources of the Revenue contradicts the point made earlier in the chapter in connection with the 'in terrorem' operation of the legislation.

66 The Law Society, for example, advances two further reasons. First the costs to taxpayers in computing, and perhaps disputing, the extent of their liabilities will be out of all proportion to profits of £20,000 per annum. Second, new offshore business ventures which may be struggling to establish themselves should not be subject to additional tax burdens. The raising of the threshold would lead to the charge being levied only on businesses which have already succeeded in establishing themselves. (See the Law Society, 'Taxation of International Business', Memorandum by The Society's Standing Committee on Revenue Law, February 1984, pp. 5-6).

67 ICTA 1988, S. 749(7).

68 ICTA 1988, s. 748(3)

69 Other examples include the following: the Revenue operate a discretion as to whether or not the 18 month period referred to in the acceptable distribution test provisions may be extended (see ICTA 1988, Sch. 25, para 2(1)(b)); they are also accorded a discretion in effect under ICTA 1988, s. 748(2) and, further, are empowered to change the terms of the Excluded Countries test at will. There are also various definitions or provisions (e.g. in para's 5-12 of Schedule 25) which are relatively opaque, such that the practical application and interpretation adopted by the Revenue is likely to prove of considerable significance in the operation of the law.

70 The degree of influence on the application of the legislation arising as a result of the Inland Revenue's attitude to it and 'discretion' in applying it is perhaps well reflected by the recent change in emphasis of the Revenue's use of the legislation. At a general meeting of the International Fiscal Association in London in 1987, there was widespread agreement amongst international tax specialists that a significant change in the Revenue's use of the CFC provisions had occurred as a result of the recent change in the chief Inland Revenue official overseeing the legislation. As a result of this change, it was generally agreed that there had been a move from a rigorous and somewhat pedantic application of the provisions by the Revenue to a 'looser' approach under which the Revenue are prepared to compromise and make agreements. At the same time, it had been noticed there was also a change in the use of directions under the CFC provisions by the Revenue. Formerly, directions under the legislation were issued in extreme cases only and generally as a matter of last resort. Since the change of official referred to above, however,

directions under the legislation appear to have become rather more common. In addition, the Revenue are generally following such directions up with assessments and taking a more aggressive stance in seeking to recover what they consider to be the tax due. The combination of these changes clearly has a significant impact on the application and operation of the CFC legislation.

71 Letter to Financial Times from Malcolm Gammie, 17 April 1984. Similar concerns are also expressed by M. Finney; 'Impact of CFC Rules on Captive Insurance', The Accountant, 3 February 1986, p.27.

72 ICTA 1988, S.750

73 Inland Revenue Press Release: 'Excluded Countries List and Clearance Procedure', 16 July 1984, para. 2.

74 B.J. Arnold, 'The Taxation of Controlled Foreign Corporations : Defining and Designating Tax Havens - II', British Tax Review, 1985, p.362 at p.368.

75 See further the tabulation of countries designated as tax havens by one or more of Australia, France, Germany and Japan and Spitz Tax Havens Encyclopedia in B.J. Arnold, 'Tax Havens Lists', 52 Taxes International, February 1984, p.15 at p.18.

76 The fact that Venezuela, for example, can be, with confidence, regarded as a non-tax haven by the U.K. yet be regarded as clearly a tax haven by the other countries mentioned raises interesting questions which are pursued in the final part of this thesis.

77 Inland Revenue Press Release, 'Controlled Foreign Companies excluded countries list and clearance procedure', 16th July 1984, paragraph 3.

78 Inland Revenue Press Release, 'Controlled Foreign Companies Excluded Countries List and Clearance Procedure', 16th July 1984, p.3. See also ICTA 1988, s.749(1).

79 Note 78, Ibid.

80 With regard to the U.S. rules, see for instance, ss 861, 862, 863, 864, 865, 871, 881, 884 and 904 of the Internal Revenue Code and accompanying regulations.

81 For example, in a U.K. context, there are occasional difficulties in determining whether trading activities are to be regarded as constituting an activity taxable under the rules of Schedule D Case I

or Schedule D Case V (see further Mitchell v Egyptian Hotels [1915] AC 1022).

82 The definition in ICTA 1988, s. 750(1) of territories with a lower level of tax is to be changed as a result of the changes proposed in the Finance Bill 1993. the 'less than one half' of corresponding U.K. tax test is to be amended to less than three quarters. See Finance Bill 1993, Clause 118.

83 However, it would still be possible for a Hong Kong company to fall outside the CFC charge as a result of the application to it of other exemptions, e.g. by fulfilling the exempt activities test of ICTA 1988, s. 748(1)(b) and Schedule 25.

84 ICTA 1988, s. 749(3).

85 The rate is currently 33% following FA 1991 ss. 23 and 24 and ICTA 1988, s. 8(5).

86 For example a flat fee basis in the order of £500 formerly applied to Guernsey and Jersey exempt companies. The exempt company regime has now been amended in both locations. In Guernsey, for example, it is now also possible to take advantage of an 'International Company' which will pay tax at a rate up to 20%, as negotiated with the Guernsey tax authorities.

87 Note 85, Ibid.

88 This point has been confirmed to the author by a member of the International Tax Department of Deloitte Haskins & Sells, who was until 1987 one of the Inland Revenue's five-man team in Technical Division administering the CFC legislation. The task of ensuring a uniform application and interpretation of the CFC measures is necessary, according to this individual, in large part because of the borrowing of definitions from other parts of the Taxes Act and as a result of the required recourse to comparable legislation overseas.

89 The comments made in the text are based on the author's own experience of dealing with the Inland Revenue and based on discussions with a large number of fellow practitioners.

90 The position can be contrasted with the discussions involving the Inland Revenue, Stock Exchange, Bank of England and The Stock Borrowing and Lending Committee in relation to the new U.K. stock lending and manufactured dividend regime (see ICTA 1988, s. 129 and Schedule 23A). In the course of these discussions the Inland Revenue has acknowledged - even if on only an informal basis - the various

difficulties that would be created by particularly complicated legislation or regulations.

91 The contributions made by the Institute of Directors in particular gave appropriate emphasis to the fundamental issues raised by the legislation.

PART D

EVALUATION OF THE UNILATERAL APPROACH AND CONCLUSIONS ON ITS CONSEQUENCES FOR INTERNATIONAL FISCAL LAW

CHAPTER 8

EVALUATION OF UNILATERAL ANTI-TAX HAVEN LEGISLATION

INTRODUCTION

This and the following final chapter represent the conclusion of this thesis. Since the conclusion is spread over two chapters it is necessary to set out below the object of each.

This thesis has concerned itself with the consequences of CFC legislation for IFL and the development of IFL. The nature of this chapter is to set out conclusions which may now be drawn in connection with the enquiries relating to CFC legislation: the emphasis is therefore directed to the CFC element of the thesis. Having drawn these conclusions it will then be possible to proceed in the final chapter to conclusions on the question posed at the outset, namely the consequences for IFL of unilateral anti-tax haven legislation. The emphasis in the last chapter is therefore directed to the broader issues concerned with IFL, such as the impact of CFC legislation on the primary objective underlying IFL.

Thus, this chapter draws together the main strands of the preceding chapters of this thesis and concentrates in particular on important issues which are common to both the U.S. and the U.K. CFC rules. This prepares the ground for the conclusions in the final chapter as to the consequences for IFL of unilateral anti-tax haven legislation.

This chapter is organised into six distinct sections.

The first section considers the assumptions that are common to the approach to CFCs taken by the tax authorities of both the U.S. and the U.K.. The discussion focuses on the attitude and approach to "tax havens", the identification of tax avoidance activities and the assumed identity of interests between a CFC and its shareholder.

The second section of the chapter is given over to a consideration of the official approach to analysis of the perceived problem of CFCs and its implications in the context of this thesis.

The third section of the chapter deals with the relationship of CFC provisions to existing double tax treaties and the implications of this point for IFL.

The discussion then moves on, in the fourth section of the chapter, to consider the degree to which CFC legislation in general satisfies the criteria to be applied in appraising substantive IFL - i.e. the policies and principles of IFL - which were established in Chapter One.

The above discussion leads - in section five of this chapter - to a consideration of the legitimacy of the CFC legislation in general and this in turn leads, in the concluding section of this chapter, to a consideration of the necessity for CFC legislation in general.[1]

ASSUMPTIONS OF THE CFC LEGISLATION

There are certain assumptions which represent the basic premises on which the CFC legislation is based and which account for its selective nature. These assumptions relate to:

1. Tax havens.
2. The identification of tax avoidance activities.
3. The identity of interests between a CFC and its shareholder.

Each of these will be considered in turn.

1. Tax Havens

It is clear from earlier chapters that the CFC measures of the U.K. and the U.S. are directed against tax haven companies, although both the U.S. and U.K. legislation avoid any reliance on (or mention of) the term "tax haven". By different routes, the U.S. and the U.K. legislation avoid the need to identify the tax havens against which the CFC measures are directed. The U.S. legislation also avoids completely the need to define what a tax haven is whereas the U.K. legislation, with its concept of lower lever of taxation (which grew out of official discussions on "privileged tax regimes") is rather more definite in setting out the nature of the tax jurisdictions against which it is directed.

The attitude to tax havens on the part of both the U.S. and U.K. fiscs has been specifically considered in detail in earlier chapters. When the earlier discussion of tax havens in Chapter Three is taken into account, it is clear that both the U.S. and U.K. consideration of tax havens is relatively simplistic. A one-dimensional concept of "tax haven" is assumed, virtually without any analysis whatsoever. There is therefore no recognition of the varying types and functions of tax havens nor of the fact that in reality the "tax haven" concept is somewhat amorphous, covering a very wide range of states with a multiplicity of fiscal systems (including, as has been noted earlier, the U.K.).

Even if attention is directed only to states with no tax or relatively low rates of tax in comparison to the state operating CFC legislation (and this seems to be implicit in the official U.S. and U.K. analyses) some form of further analysis is still required.

The official approaches are markedly indiscriminate in their approach to such no-tax or low-tax states. No distinction is therefore made, for example, between simple no-tax havens and offshore financial centres which have a genuine trading function in the market place.[2]

This underlying approach is therefore considered over-simplistic. However, even such a simplistic approach to tax havens is not without its difficulties from an operational point of view. As has been noted in connection with the earlier discussion of the U.K. excluded countries list, Venezuela appears on that "white" list yet is also featured on the "black" lists of the CFC legislation of France, Germany and Japan. Other countries (such as Ireland) are not on any CFC black list but are, for example, featured in Barry Spitz's leading Encyclopedia on Tax Havens[3] and are regularly used for tax-planning purposes.[4]

Whilst the U.K. "white" CFC list is occasionally updated, the "black" CFC lists of France and Germany have not been updated since their initial publication. This is probably a reflection on the difficulty facing any tax authority in attempting to keep up to date with the numerous and increasing changes to tax systems around the world. Even the U.K., which has attempted to keep its list updated, appears to have overlooked certain of these developments.[5]

There may in addition be something of a localised concern over the perceived problem of tax havens. According to one author:

> "To some extent the jurisdictions specified as tax havens by a particular country reflect that country's location. Therefore, Japan is primarily concerned with tax havens in the Pacific Basin and has listed a number of jurisdictions located there that are not listed by other countries. Similarly, France and Germany are more concerned with European havens".[6]

All the above factors undermine the validity of the simplistic approach to the subject of tax havens adopted by countries with CFC legislation and also raise doubts as to whether such an approach can be satisfactorily operated on an administrative level alone.

Based on the discussions in earlier chapters on the attitude to tax havens of the U.S. and U.K. fiscs, it may be observed that both fiscs have a deeply suspicious attitude towards the use of tax havens.[7]

The suspicion in respect of tax havens on the part of the U.K. and U.S. fiscs leads to the (unacknowledged) assumption by them that the use of a tax haven location is generally attributable to a tax avoidance motive.[8] There is therefore little apparent willingness to consider non-tax motivations for the use of such locations (such as are considered in Chapter Three of this thesis). This is reflected in the official analyses of the use of tax havens. Both the U.S. and U.K. fiscs provide evidence of the increased use of tax havens made by domestic taxpayers,[9] yet both fiscs fail to provide any further analysis: it is as though the mere use (or increased use) by domestic taxpayers of "tax haven" locations, if demonstrated, is sufficient in itself to establish the case for anti-tax haven legislation. In view of the increasing internationalisation of virtually all market sectors and the comments made in Chapter Three on the wider (non-tax motivated) uses of tax havens, the view taken by the U.S. and U.K. fiscs is clearly not adequate.

A proper analysis of the use made of tax havens is therefore required before the conclusions already drawn by tax authorities as to the existence and consequences of international tax avoidance can reasonably be substantiated.

It is likely that certain abuses may be highlighted by such an analysis. For example, in the transfer pricing area, tax havens have certainly been used in the past for the purposes of artificially diverting and accumulating profits and it is perhaps doubtful if all cases of such abuse have been completely eradicated by the various laws which regulate, for tax purposes, transfer prices used between connected parties. Tax havens may also be used for other activities involving international tax avoidance. There is also evidence linking tax havens with activities involving tax evasion and other criminal activities.[10] It is therefore not suggested here that low-tax or tax haven states are not used for tax-motivated purposes. However, it should be emphasised that evidence on the scale of such

uses of tax havens is not available and there is therefore no reason to conclude that the use of tax havens for these purposes is necessarily materially different from the use made of non-tax haven states for the same purposes. Notwithstanding these comments, it is recognised that a low or no rate of tax applying in a "pure" tax haven is, ceteris paribus, likely to encourage the use of that state as a location for "money box" and similar companies in comparison with high-tax states. Therefore, it is understandable that tax authorities in high-tax states may wish to consider whether measures to prevent potential abuse are necessary. However, this by no means in itself establishes the case for legislation directed against controlled foreign companies. Indeed, even if evidence were available to confirm significant abuse of tax havens (assuming that the meaning of "significant abuse" could be properly clarified) it would still remain to be proven that CFC legislation would be effective to deal with such abuse and could be reconciled with the primary objective underlying IFL, (namely the removal of fiscal distortions to the free movement of capital and persons and the exchange of goods and services) and the policies and principles of IFL.

The earlier discussion in Chapter Three suggested that the use of a tax haven for tax purposes should not necessarily be attacked or deprecated. If a commercial operation is carried on in a tax haven using a subsidiary company as the trading vehicle (which may therefore be a CFC), rather than a branch, and this decision is made for tax reasons, the choice may simply reflect the wish to be subject to the tax regime of one state (the tax haven) as opposed to another (the state of the parent company). An alternative view of this same motivation is that it represents outright tax avoidance, or possibly evasion. These two positions represent the two poles of the possible spectrum of views. Unfortunately, both the U.S. and U.K. official analyses assume the latter view without any consideration of the rights of the taxpayer in this situation to choose which tax regime is to apply. This assumption seems to be based on further assumptions relating to the nature of international tax avoidance activity, a matter to which the present discussion now turns.

2. The Identification of Tax Avoidance Activities

Even assuming that tax haven states can be readily identified, the fact that such states are (arguably in common with virtually all other states in the world) probably used for various tax-motivated purposes, (whether involving "legal" avoidance activities or unlawful "evasion" activities), does not in itself provide grounds for anti-tax haven legislation of the type enacted by the U.S. and the U.K. Before establishing such grounds it would logically be necessary to establish the following:

(i) The scale and type of activity involving tax havens by domestic taxpayers.

(ii) The degree to which domestic taxpayers were engaged in "abusive" activities involving tax havens, together with an explanation of the criteria by which activities are to be classified as "abusive".

(iii) The effect of the activity in (ii) above on domestic tax revenues.

(iv) The extent to which existing legislation could be applied to counter the "abusive" activities identified in (ii) above.

For the avoidance of doubt it should be made clear that it is not being suggested that there is any rule of international law or indeed any substantive enactment, policy or principle of IFL which dictates the use of the four steps referred to above. It would therefore be open to a state in which, for example, there is little perceived tax abuse by residents involving the use of CFCs, to enact legislation directed against CFCs. Such legislation in these circumstances may have limited impact (and might be rarely if ever applied) but there would be nothing in the above four steps to prevent the enactment of that legislation. Similarly, a state which did perceive significant and widespread abuse by CFCs may enact legislation directed against them, quite without regard to the above steps. As is explored in this chapter, there may be a number of grounds as to why that law is

bad law, judged from the perspective of IFL, but the failure to comply with the four steps set out above would not in itself be an argument to prevent the enactment of that law. It would, however, provide a strong hint that those setting fiscal policy are doing so in a disorganised and illogical manner, completely overlooking, for example, whether such legislation is really needed in the first place. It may also suggest that those in charge of setting fiscal policy had moved away from the objective of raising revenue[11] to the objective of fighting avoidance - or even perceived avoidance - for its own sake.[12]

In the U.K., a modest attempt was made by the fisc at tackling steps (i) and (ii) above (but without explaining properly the reasons why the activities were abusive) in the course of the consultative process.

Steps (iii) and (iv) were not seriously considered, although, in connection with point (iii), it was suggested (without any supporting evidence or comment) that the CFC legislation would prevent "tax leakage of around £100 million a year".[13]

Whereas the discussions in the U.K. centred around the phenomenon of international tax avoidance (one of the major Inland Revenue papers was entitled "International Tax Avoidance"), the discussions in the U.S. in the early 1960's were primarily related to the availability to tax haven corporations of tax deferral, and the consequent postponement of U.S. tax as a result of the ability to retain income in a subsidiary company in a low-tax overseas jurisdiction. Thus, although the facts referred to by the official discussions in the U.S. and the U.K. were the same, the emphasis in the U.S. was on tax deferral and the consequent tax advantage available to overseas subsidiaries that was not available to companies operating solely in the United States. The official discussion was therefore primarily concerned with achieving parity of tax treatment between domestic corporations and CFCs. Probably largely as a result of this difference in emphasis, the U.S. discussion of steps (i) to (iv) above was almost non-existent.

It is notable, however, that the U.S. discussion of tax deferral provides little analysis of the deferral concept itself. Indeed, the assumptions that were made in the U.S. in 1961-2 as to the nature and availability of deferral run virtually parallel to those made in the U.K. in 1981-4 as to the use of tax havens.[14] In the official U.S. discussions, the motivation of taxpayers gaining a deferral "benefit" is not subject to analysis. Despite the lack of empirical analysis however, it is stated that;

> "Recently, more and more enterprises organised abroad by American firms have arranged their corporate structures... so as to exploit the multiplicity of foreign tax systems... in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad...".[15]

Again, the evidence and analysis to support the pejorative view of such "exploitation" exclusively for tax purposes as is mentioned above is lacking, as is any analysis of deferral which would support the application of Subpart F.

The discussion of international tax avoidance in Chapter Two suggests that no clear explanation or definition of the concept of tax avoidance has yet emerged. Both the U.S. and the U.K. follow the trend identified in Chapter Two by avoiding any attempt to define the tax avoidance to which exception is taken but nonetheless setting out the type of activities (and types of income) to which their CFC provisions are to apply. The second assumption made, therefore, is that the activities (and types of income) to which the CFC provisions apply represent "avoidance" activities which are legitimate targets for domestic CFC legislation.

The chief element of this second assumption is the consequential selectivity of the legislation: both Subpart F and the U.K. CFC provisions apply only to certain selected types of income. The details of the income subject to the CFC provisions in the U.S. and the U.K. have been considered in earlier chapters. From that earlier discussion it is possible to summarise the position (somewhat broadly) to

the effect that it is passive income and related party income which are the targets of the CFC legislation.[16]

The difference between the above categories of income and all other categories of income seems to be that tax authorities perceive that the former types of income can easily be diverted to tax haven subsidiaries and should therefore be subject to the CFC provisions. It is worth stressing that there is nothing inherent in these "tainted" categories of income which distinguishes them from other types of income, other than that, according to the tax authorities, they can more readily be diverted to tax haven locations. Considered in this way, the heavy-handed nature of the CFC legislation becomes obvious; the position taken by the tax authorities enacting CFC legislation seem to be that the legislation is justified to close off in advance any potential opportunity to divert the tainted categories of income to a tax haven company.

It might be argued that passive income, and possibly also related party income, is not actually earned in the foreign jurisdiction concerned and therefore, on the basis that such income is merely a return on the capital of the domestic corporation, it may properly be taxed under CFC provisions. If such an argument were to be sustained, it would clearly need to be developed further (and this has not been done in the official U.S. or U.K. discussions of CFC legislation). For example, it would need to be clarified what is meant by saying that income is not earned in the foreign jurisdiction. Further, it would also be necessary (from a logical perspective) to address the four steps of analysis referred to earlier in this chapter. In that regard (and as will be considered in detail later), it is considered that the analysis arising from step (iv) - the extent to which existing legislation could be applied to counter the "abusive" activities - would in any event completely remove the need for CFC legislation even assuming that the above argument (that passive and related party income is not earned in the foreign jurisdiction) is correct.

However, the assumption that passive or related-party income can simply be switched from one jurisdiction to another by the tax-avoiding taxpayer is over-simplistic. There are a number of constraints which limit the extent to which any such transfers of income or activities can be made.[17]

It is notable that both the U.S. and U.K. fiscs have failed to make an adequate case in support of their respective CFC legislation. Such justification as there is for the measures seems to rest on the proposition that the categories of income attacked are potentially susceptible to diversion techniques involving tax havens. It is certainly questionable whether this justifies CFC legislation of the sort that has been enacted.

3. The Identity of Interests Between a CFC and its Shareholder

The third key assumption made by the fisc applying the CFC legislation is that there exists an identity of interest between the overseas subsidiary (the CFC) and its domestic shareholders such that income of the CFC may properly be attributed to the shareholders.

With regard to this point the conventional understanding of the relationship between a shareholder and the company in which the interest is held should be noted. The Commentary on the 1977 O.E.C.D. Model Convention on Income and on Capital states the position thus:

> "The position is different for the shareholder; he is not a trader and the company's profits are not his; so they cannot be attributed to him".[18]

Indeed, the legal distinction between a shareholder (whether a corporate shareholder or not) and the company in which the interest is held is the basis of corporate existence in both U.K. and U.S. law.[19]

Neither the U.S. Department of Treasury or Internal Revenue Service nor the U.K. Inland Revenue has ever published a reasoned justification as such of the attribution of the income of the CFC to the (shareholder) parent.

This attribution is presumably based upon the earlier two assumptions considered relating to international tax avoidance and tax havens. However, even if the earlier assumptions made with regard to international tax avoidance and tax havens are totally warranted, it would still seem necessary to consider whether or not, and in what circumstances and for what reasons, such attribution is acceptable. (It is assumed that the mere existence of any form of international tax avoidance is not in itself the grounds for the attribution discussed above.)

Such an argument as referred to above could perhaps be developed (as least in part) by reference to the principles of profit allocation. This principle is the basis of transfer pricing legislation and could be applied to justify the allocation of profits to a company in a state where those profits have in fact been earned or, for other reasons, are directly attributable to a taxpayer within that state. However, this argument would of course lead to the question of where the profits are in fact earned. Where it is the CFC itself which is earning the profits, the argument would not support an allocation of those profits to the shareholder. Moreover, it is clear from existing official statements that the respective fiscs do not contend that the basis of the CFC legislation is that the various types of income subject to current taxation under CFC legislation have been earned in their countries. For example, the U.K. fiscal authorities manifestly wish to apply the U.K. CFC provisions "where transactions take place between a controlled overseas company and a third party".[20] Further, to the extent the argument could be applied to justify the attribution of income referred to above, there exists already legislation of a general nature in both the U.S. and the U.K. which is capable of subjecting the relevant income to taxation in any event. The relationship between existing provisions and the CFC rules is discussed further in the last section of this chapter.

One justification which has been raised to substantiate the attribution of the income of a CFC to its parent is the argument that "tax deferral" is inconsistent with the granting of a foreign tax credit because the grant of such a credit "involves treating a foreign subsidiary as inseparable from its parent".[21] A foreign tax credit is granted in respect of dividends remitted by an overseas subsidiary to its domestic parent by both the U.K.[22] and the U.S..[23]

However, this argument would need to be developed in some detail before it could become a plausible justification for the attribution of income under discussion.

The foreign tax credit mechanism is not applied in situations which are directly analogous with those in which CFC provisions operate. For example, under U.K. law, the credit will be given if not less than 10% of the voting power in the company paying the dividend is held and there is therefore no requirement for control of the overseas company in question as such.[24] Further, it is arguable that the sole function of the credit mechanism is to prevent economic double taxation and therefore the foreign tax credit mechanism is an essential part of IFL. It is also likely to be an attractive mechanism to a particular state because it will effectively remove the double tax barrier to remittances of dividends from overseas subsidiaries that may otherwise exist. This view is supported by the significance of the credit mechanism and its role in the various model double tax conventions and in double tax treaties generally. Whereas the foreign tax credit mechanism is adopted in most double tax treaties, the CFC provisions are not catered for at all and are arguably inconsistent with such treaties. (The relationship between CFC provisions and double tax treaties is considered below.) This suggests that there is some difference in character and function between the CFC provisions and the foreign tax credit mechanism and therefore that the mere existence of the foreign tax credit is not in itself a justification for the CFC provisions.

Moreover, if the logic of the argument was correct, it would seem to follow that the attribution of only certain categories of "tainted income" (in the case of the U.S.) or non-exempted income (in the case of the U.K.) was itself inconsistent. Since the foreign tax credit applies to all dividend income remitted (regardless of the activity from which the income was derived) the argument surely leads to the conclusion that all overseas income should be attributed to the state of the parent company.

It is not considered that the mere existence of the foreign tax credit mechanism is sufficient justification for any form of income attribution of the type under discussion and the above points seek to reinforce this view. The credit mechanism fulfils an entirely separate function in circumstances which are not analogous with those in which the CFC provisions operate.

It has also been suggested that it is inconsistent to tax foreign branch profits currently (as both the U.K. and U.S. do)[25] and yet to allow "deferral" of tax on the income of a foreign subsidiary.[26] This argument raises a number of points similar to those that have already been raised in connection with the foreign tax credit mechanism. The argument ignores the legal fact that a subsidiary is in law a separate and distinct entity from its shareholder, regardless of whether its shareholder is a corporate body or not. A foreign branch is dissimilar to a foreign subsidiary in a wide range of ways which lead to variances in the tax treatment of a number of events and transactions. For example, in the U.K. a subsidiary has until recently been subject to capital duty on incorporation, and will be subject to tax on its world wide profits (if the company is U.K. resident) but will qualify to take advantage of the wide network of U.K. double tax treaties.[27] A U.K. branch, on the other hand, would not formerly have been subject to capital duty and will be subject to U.K. taxation only in respect of U.K. income and gains connected with its branch activity. A U.K. branch will not be able to use the U.K.'s network of double tax treaties.[28]

These differences in the treatment accorded to a branch as against a subsidiary might be referred to as "inconsistencies" but that word falsely assumes an equivalence between the two types of vehicle and is therefore somewhat misleading: even if the activities carried on by a U.K. branch are similar to those carried on by a U.K. subsidiary, the above legal and tax differences will hold. For tax purposes, this is due chiefly to the fact that although the subsidiary is likely to be resident in the U.K. and taxed as such, the branch will not be so resident. Legally, the obvious difference is that a subsidiary operation is accorded separate legal personality whilst a branch is not.

Moreover, the assumption behind this argument that the treatment of a branch (current taxation) is inconsistent with the treatment of an overseas subsidiary (tax deferral) in such a way as to justify current attribution of the profits of a CFC is open to two further counter arguments.

First, the reasoning would strictly lead to all profits of a CFC being taxed currently rather than the "tainted" U.S. or "non-exempted" U.K. profits. As such, the argument based on inconsistency is not in itself a justification of CFC legislation in its present selective form. This point has already been made above in connection with the foreign tax credit argument.

Second, the argument assumes that a potential investor in a country will always have a direct choice as to which vehicle is adopted. This may often be the case but local laws and regulations or local commercial factors may not permit such a choice.[29] Also, the argument would seem to apply only to wholly-owned subsidiaries and not those where there are minority shareholders since in these cases there is clearly no equivalence between a branch operation and a subsidiary operation.

Therefore, in view of the above, it would appear that the argument based on inconsistency of treatment is here, as with the argument relating to the foreign tax credit, hardly proven. Certainly there are differences in treatment, but whether

these differences amount to inconsistencies, and whether such inconsistencies, even if demonstrated to exist, justify legislation of the CFC character are matters which have yet to be established.

To a large extent, the attribution of income is implicitly based on the two earlier assumptions relating to the existence of international tax avoidance and tax havens. Therefore, the degree to which such attribution is warranted will turn on the view taken with regard to those two earlier assumptions which have been discussed above. Nonetheless, in view of the foregoing discussion it would appear that the third assumption made in the enactment of CFC legislation, relating to the attribution of income, is still in need of some further justification.

THE OFFICIAL APPROACH TO ANALYSIS

In view of the discussions earlier in this thesis, it will be clear that the analysis of the perceived problem by the U.S. and U.K. fiscs was somewhat incomplete. Clearly, both fiscs took the view that there was a significant problem which required new legislation. Regrettably, the basis of that view was never explored in any detail in the publicly available documents. There was little (if any) discussion of the principles involved in the official assessment of the need for the legislation and the empirical analysis was also somewhat thin. In the U.S., there was at the time of the promulgation of Subpart F no analysis of the uses of tax havens made by U.S. taxpayers, although an extensive general study of this was later conducted (almost twenty years later) by Richard Gordon, leading to his Gordon Report in 1981.[30] In the U.K., a study into the uses of tax havens by U.K. companies was mounted by the Inland Revenue[31] but only after the legislation had been proposed and the consultative process carried on for some months. The U.K. study is in any event too brief and lacking in any analytical detail to shed much light on the use by U.K. corporate taxpayers of tax havens.[32]

The quality of the analysis is exemplified by the amount of economic data conveyed about the CFC measures. The only statement remotely connected with

the economic impact of the measures in the course of the U.K. three-year consultative process is the following:

> "We have little doubt that there are problems in this area which need to be tackled. For example, the use of controlled foreign companies in low tax countries, where avoidance of U.K. tax is the main purpose of the activity, is leading to a tax leakage of around £100 million a year."[33]

There is no reference to how the figure of tax leakage has been determined nor to how the "main purpose" of the offshore activity has been identified.

With regard to the U.S., it would appear there was a similar lack of analysis at the time of the enactment of Subpart F. Professor Stanley Surrey, who was Assistant Secretary of the U.S. Treasury at the time Subpart F was adopted, has confirmed that the legislation was not discussed in any detail at the time of its adoption.[34]

The position appears not to have been rectified in the interim as there still seems to be substantial disagreement as to the economic effects of Subpart F: a U.S. Treasury department estimate in 1981 suggested additional revenue in the order of $365-$768 million as a result of the Subpart F measures yet another (independent) study in 1976 indicated that eliminating deferral would actually reduce tax revenue.[35]

Both the U.S. and U.K. legislation makes the assumption that by putting the targeted income within the scope of the CFC legislation the perceived "loss" or "leakage" to the domestic fisc is corrected, either because the measures operate "in terrorem" to dissuade the taxpayer from using a controlled overseas company to which income is diverted or because the tax benefits arising from the use of such a company for such a purpose will be nullified by the operation of CFC legislation. In economic terms this appears to be an untested assumption. Leaving aside the possibility that the CFC provisions may not be effective in achieving

their intended purpose as a result of tax planning manoeuvres by taxpayers (such as "decontrolling" companies which would otherwise be subject to the CFC laws), it would still not necessarily be the case that the targeted income becomes subject to the relevant domestic tax charge. This is because, in some cases, the offshore activity which generates the type of income against which the CFC measures are aimed may simply be terminated by taxpayers in response to the CFC measures. For example, the application of a CFC charge may cause a particular transaction to lack feasibility in after-tax terms.

In practical terms there are situations where the marginal cost of a tax charge may rule out the viability of a transaction with the effect that a particular transaction may be carried out either without a significant associated tax cost, or not carried out at all.

The view that the imposition of a CFC charge will result in increased revenues being earned by domestic companies is based on the premise that foreign and domestic investment are substitutes, such that when foreign markets or investment opportunities are, for one reason or another, rendered unattractive, the investment will simply be reallocated to the domestic market. This premise may well not be correct.

The point is recognised by a U.S. Treasury Study on the undistributed income of CFCs. In discussing the effects of the CFC charge, it is noted:-

> "Some observers believe that investment would be partly shifted back to the United States, thereby increasing U.S. corporate earnings.... . Other observers countered that little or no investment would be shifted back to the U.S. They argue that profitable investment and production opportunities are highly specific both in time and place, and that the loss of foreign markets abroad does little to create new investment opportunities in the United States. Indeed, the loss of foreign markets might "impair" the access of

> American producers to new foreign technology, and might impede the realisation of economies inherent in large scale production and in international specialisation, with a consequent attenuation of domestic investment opportunities".[36]

A similar point is made by one commentator on the U.K. legislation:

> "We do not accept the implicit assumption that a reduction in tax avoidance through the use of havens... causes an equivalent increase in United Kingdom tax revenue. At the very least, there will be a substantial wastage as taxpayers react to anti-haven legislation by rearranging their affairs, for example through emigration or a shift to other lines of activity; and the same process taken further will cause tax revenue to fall through the suppression of "avoidance" instead of rising. A fall in tax revenue through the suppression of avoidance is nothing improbable or untypical: for example, section 482, ICTA 1970 may well have this effect at present..."[37]

It might be argued that the CFC measures are a success if they prevent these types of transactions notwithstanding that, in such cases, the measures do not actually generate revenue. Such an argument would be based on the premise that these types of offshore transaction are "abusive" and therefore should be prevented. However, any argument in favour of using the CFC measures to simply prevent certain activities of CFCs taking place will rapidly run into questions as to the justification of such legislative measures. As has already been suggested in that regard, the case for the CFC measures has not been convincingly argued or established in either the U.S. or the U.K.

Moreover, such an argument takes no account of the consequential economic effects of the offshore transaction. It may be that domestic revenue is actually reduced because the offshore transaction is not carried out. This might happen in any number of ways, for instance where there is onshore activity (which generates

profits subject to taxation) arising as a direct or indirect consequence of the offshore transaction (e.g. onshore reinsurance by a domestic company of an offshore insurance policy written by its overseas associate; onshore underwriting of an issue organised offshore, etc).[38]

CFC LEGISLATION AND DOUBLE TAX TREATIES

There has been little official discussion in either the U.K. or the U.S. of the relationship between the CFC legislation and double tax treaties negotiated by those states. There is certainly no discussion of the apparent difficulties that arise when the operation of CFC provisions effectively produces a tax result which is different to the result which would have been applied under the terms of an existing double tax treaty.[39] Indeed, there seems to have been no discussion on this point in the course of the U.S. discussions and only the briefest of references to double tax agreements in the course of the U.K. consultative process.[40] The difficulties are not confined to the realm of discussions on IFL but involve substantive legal issues also, although these are not discussed further here.

From the perspective of IFL, the difficulties stem from the fact that the CFC measures effectively represent the taxation of the CFC itself, notwithstanding that the charge is, legally, levied on the domestic parent of the CFC. (Since the computation of the CFC charge is determined by reference to the profits and circumstances of the CFC the economic reality is that the CFC itself is being taxed, although for the convenience of the domestic tax authorities applying the CFC legislation the tax is levied on and collected from the domestic parent).[41] However, as noted earlier, where CFCs are resident in a state with which the U.K. or U.S. (as the case may be) has a treaty, then, under the terms of that treaty, they should generally be subject to U.K. (or U.S.) tax only if they have a permanent establishment in that state, and then only on the profits properly attributable to that permanent establishment. It would therefore appear that the taxation of CFCs contradicts the double tax treaty approach.[42]

The relationship of the CFC provisions to double tax treaties and the difficulties identified above are not merely academic points. The U.K. has treaties with a number of states which are regarded as low or no tax havens (e.g. with Barbados, Cyprus, Isle of Man,[43] St. Lucia) and the U.S. similarly has treaties with such states (e.g. with Luxembourg and Trinidad and Tobago). It is therefore not possible to argue that no clash between CFC provisions and treaty provisions can in practice arise.

Since there is no considered official discussion of the matter, it is not possible to set out the view of the Inland Revenue or IRS on this issue. Presumably, it might be argued by those fiscal authorities that since the CFC provisions do no more than attribute income to the jurisdictions from which such income was artificially diverted, there cannot in principle be a clash between those provisions and the provisions of double tax treaties since the CFC provisions merely restore the fiscal result which should have arisen anyway. However, this line of argument would require some considerable development before it could represent a complete answer to the apparent conflict of CFC legislation and double tax treaties. For example, one of the most pressing matters that would need to be established in support of this argument is the existence in each case of an acceptable "nexus" to justify the taxation of the CFC by the state applying the CFC provisions. Applying the generally accepted views as to the circumstances in which a state may legitimately exercise its taxing powers, it is difficult to see how the existence of such a nexus can in such a case be established.

From the perspective of IFL the point of most concern is that the relationship of these CFC provisions to existing double tax agreements was effectively totally ignored in the enactment of both the U.S. and U.K. CFC legislation. Since double tax agreements have to date proved to be the most effective instrument of IFL, this aspect of the enactment of CFC legislation is of particular concern. Unfortunately, this unilateral disregard for double tax treaties is not confined to this single instance and the U.S. in particular has recently been heavily criticised for its apparent willingness to introduce unilateral measures which specifically

override or contradict provisions of double tax treaties it has negotiated.[44] The implications of this point for IFL are discussed further in the final chapter of this thesis.

CFC LEGISLATION AND THE POLICIES AND PRINCIPLES OF IFL

This section of this chapter concentrates on a consideration of the CFC legislation from the perspective of the two key policies of IFL, equity and neutrality. However, it should be noted that a number of the matters already discussed earlier in separate sections of this chapter are of equal relevance to the present section in view of their significance from the perspective of the principles of IFL (for example, the discussions on the assumptions of the CFC legislation and the relationship of that legislation to double tax treaties). The present discussion therefore provides an opportunity to deal with certain issues which have not yet been discussed in this chapter.

Equity

There are a number of issues which should be raised from the perspective of equity in connection with the CFC legislation.

One fundamental matter, reflected in the CFC legislation of all states which have enacted such measures, is the fact that the legislation completely ignores the autonomy and separate identity of the relevant subsidiary CFC. This approach is contrary to the conventional approach to the separate personality generally accorded to companies[45] and also contrary to the approach adopted for the purposes of transfer pricing provisions. Whereas those provisions typically regard the parent and its subsidiary as two entirely separate entities to be treated as dealing at arm's length, the CFC provisions in effect ignore the status of the subsidiary as a separate and autonomous entity and instead attribute its profits (in whole or in part) to the parent in whose hands they are taxed. The conceptual justification for this treatment has been considered earlier in this chapter. At

best, it may be concluded that the case has not been proven. In consequence, the treatment is somewhat suspect on that ground alone from the perspective of equity. Indeed, given that a domestic shareholder may be subject to a tax charge under the CFC provisions even if no remittance has been received from the overseas company, the fact that no proper justification in principle has been made is particularly regrettable.

The case supporting the inequitable nature of CFC legislation is further strengthened by the blatant lack of symmetry in their operation: although profits of a CFC are to be allocated to the parent for current taxation, losses are not. Again, a comparison with the transfer pricing principle provides an observation of relevance (although the comparison is not entirely straightforward[46]): whereas the transfer pricing provisions should normally be applied consistently in a way which may both increase or reduce taxable profits attributed to a state (in the case of a sale at an undervalue by a domestic company and a sale at an overvalue by a domestic company respectively[47]), the CFC provisions lack any analogous symmetry since, in view of the approach taken in the case of losses, they can only increase the taxable profits attributed to the state applying the CFC legislation.

This treatment seems clearly inequitable judged solely according to the assumptions that presumably underlie CFC legislation since, if the results of the CFC are to be attributed to a domestic shareholder on the presumed basis that those results are in reality his, it would seem necessary to apply this treatment consistently, and this would seem logically to mean the attribution of both profits and losses as appropriate.

A further matter which has been referred to in the discussions on both the U.S. and U.K. provisions is the holding required by a domestic shareholder for that shareholder to become potentially subject to the legislation. In the case of both the U.S. and the U.K. a 10% holding is sufficient for this purpose. In the earlier discussion this figure was criticised for being set too low since a shareholder with a 10% interest is in practice unlikely to have a significant voice in the

management of the offshore CFC. It is therefore inequitable that such a shareholder is taxed under the CFC provisions on the contrary assumption. Domestic shareholders should not be subject to current taxation on the income of a foreign company under the CFC legislation if they do not have sufficient power to cause it to distribute funds with which such tax can be paid. However, the U.S. and U.K. CFC legislation will apply if more than 50% of the shares of a foreign company are owned in aggregate by domestic shareholders holding 10% or more of those shares, even if those domestic shareholders are not connected, and even if they are not aware of each other's existence. The approach seems to be based on the bizarre theory that all domestic shareholders have a common interest and therefore should be treated as a group which effectively controls the foreign corporation. In the case where there is no connection between domestic shareholders (let alone where they are unaware of each others existence), this approach seems completely unreasonable and without justification.[48]

The selective nature of the CFC legislation has already been referred to in the earlier discussion in this chapter relating to the identification of tax avoidance activities and it is also of relevance to the discussion of neutrality below. It should also be noted that the matter is also relevant from the perspective of equity since, unless the selectivity can be justified (and the earlier discussion concludes that the available arguments fall well short of justifying the CFC legislation), the result will amount to an arbitrary, and therefore inequitable, basis for taxation.

Another concern from the perspective of equity is the degree of discretion in applying the legislation which is delegated to the tax authorities. The situation is possibly of more concern in the U.K. due to the fact that a direction from the Board of Inland Revenue is required before the U.K. legislation can apply,[49] whereas Subpart F applies automatically. The U.K. requirement that a direction be made before the legislation can apply raises a number of questions as to whether the Inland Revenue have the resources and ability to apply the U.K. legislation on an even-handed basis. Concerns on the point are perhaps exacerbated by the more detailed legislative points (discussed in Chapter Seven)

which the Inland Revenue is effectively given discretion to resolve (e.g. application of motive test, treatment of loan creditor as a person with an interest in a CFC, etc). Notwithstanding the automatic application of Subpart F, there are similar concerns concerning the discretion of the Internal Revenue Service in applying the legislation. These have been referred to in the discussion in Chapter Five.

Where important rules are either not contained or not fully clarified in the relevant legislation but left to the tax authorities, the application of the CFC provisions becomes less certain and potentially uneven comparing the position of one taxpayer to another, the primacy of the legislation is undermined and the taxpayer made subject to administrative dictate rather than the rule of law. All of these results would have deleterious consequences for the policy of equity of IFL.

Neutrality

Although official comments on the CFC legislation claim that the legislation has a neutral effect, it is doubtful, on a number of counts, if this is so.

The official reasoning behind the need for the legislation has been discussed in connection with both the U.S. and the U.K. in earlier chapters. As a result of the different emphasis given to the official discussion of the legislation in the U.S. and the U.K. prior to its enactment it is not possible to give a single statement of the official intention behind the two sets of provisions. In the U.S. the intention was to prevent what was perceived as unjustified tax deferral whilst in the U.K. the intention was to prevent what was perceived as the improper diversion and accumulation of profits overseas. However, the different U.S. and U.K. emphases are arguably two sides of the same coin and, in both cases, the official view was that the measures would prevent tax-driven arrangements to shelter income from domestic taxation. On this basis, the official position in both cases was that genuine business activities would not be affected.

As has been seen in the discussion in earlier chapters, seems unlikely to be true. Indeed, it may be argued, on the basis of the discussion in earlier chapters, that it necessarily could not be the case. With regard to the U.S., for example, and accepting (somewhat unrealistically) for one moment the propriety of the anti-deferral approach, even if all forms of deferral had been stopped by an expanded Subpart F as was originally intended, this would not have a merely neutral effect but would clearly favour domestic investment, a point conceded by a 1976 U.S. Treasury study on Subpart F.[50] With regard to the U.K., the earlier discussion has established that there are various grounds (both conceptual and practical) for doubting whether the U.K. CFC provisions could ever function solely to enable the taxation in the U.K. of profits diverted and retained overseas for tax purposes.

The different approaches to a motive test illustrate the point. In the U.S. legislation, there is now a purely objective test which has been substituted for the earlier subjective test of whether or not the CFC had been formed or availed of to reduce its tax liability. The new test, following the Tax Reform Act of 1986 requires the relevant income actually to be subject to tax at a rate of 90% or more of the corresponding U.S. taxation on the income.[51] The major weakness of the U.S. approach is that the percentage amount of tax suffered on overseas activities is arguably completely irrelevant in determining whether genuine business activities are being conducted. The policy approach that the overseas activities are not "genuine" and therefore should be taxed under Subpart F where the applicable foreign tax rate is less than 30.6% (34% (U.S. rate) x 90%) is certainly a failure from the standpoint of the criterion of neutrality.

The U.K. motive test is perhaps even less satisfactory, although the U.K. taxpayer will of course only need to consider it if a direction under the U.K. CFC legislation is given.[52] The U.K. test has been discussed in detail in Chapter Seven, from which discussion it may be concluded that the test is most unlikely to provide adequate protection in the case of CFCs conducting non-tax motivated operations overseas.

Therefore, despite the various official protestations of the U.S. (for example, "there is absolutely no thought of penalising private investment abroad which rests upon genuine production or market activities")[53] and the U.K. (for example, "we are determined that legislation to counteract avoidance should not in any way be damaging to genuine business activities")[54] the respective motive tests appear unreasonably restrictive and therefore unlikely to ensure that the respective CFC provisions have a neutral effect on genuine business activities.

The selective nature of the legislation is also likely to have a non-neutral effect on certain types of business activities. Most obviously, the types of activities which are made subject to CFC legislation are made relatively unattractive in comparison with other types of activities which are not subject to the legislation. Further, as has been noted in the earlier discussions on the impact of the CFC measures on the banking and insurance sectors, the U.S. and U.K. CFC measures may have the effect of simply ruling out the viability of certain types of overseas business.

Similar concerns have been experienced in the case of the CFC legislation of other states.[55]

Against the above arguments it might be objected that CFC legislation is required to <u>restore</u> neutrality between, for example, U.K.-based and tax haven-based companies established by U.K.-based multi-nationals. However, such a view would involve the fisc concerned in taxing not only residents within the jurisdiction of that state but also residents in overseas states (i.e. the CFCs). Such taxation would need to be justified by reference to the established concepts of taxation, residence and taxable presence, which have been discussed throughout this thesis, and particularly in Chapter One. This matter is discussed further in the next section of this chapter below. For present purposes, it should be noted that any argument that CFC provisions are required to restore neutrality between domestic and tax-haven based operations organised by a domestic-headquartered multi-national inevitably raises a number of fundamental issues of relevance to IFL and

is not therefore a comprehensive justification of CFC legislation from the perspective of neutrality.

For all the above reasons (and the more detailed discussions in Chapters Five and Seven) the CFC legislation in general is not a conspicuous success according to the criterion of neutrality.

There are, of course, further detailed points on the degree to which the CFC provisions comply with the policies of IFL and which are of specific relevance to the U.S. and U.K. legislation. These points have been considered as relevant in earlier chapters.

LEGITIMACY OF THE TAXATION OF CFCs

The question of the legitimacy of measures enacted to tax currently the overseas profits of a CFC in the hands of its shareholders is an issue of fundamental importance which received relatively minor attention in both the U.S. and the U.K..[56]

In both the U.S. and the U.K. the legitimacy of the measures was assumed by the fisc, presumably, as a result of the key assumptions behind the legislation (which have been discussed earlier in this chapter).

Since the CFC tax charge is levied on domestic shareholders in the case of both the U.K. and U.S. legislation, there is arguably no strict legal reason to deny the validity of the tax charge. However, since this thesis is concerned with the primary objective underlying IFL and the policies and principles of IFL which flow from that objective as explained in Chapter One, the strict legality of the substantive CFC provisions is in any event not necessarily an adequate response to the question of their legitimacy, judged from the perspective of IFL adopted in this thesis. Therefore, there remain questions as to how the measures are reconciled to the conventional (and widely-accepted) approach to taxation adopted in the

U.S. and the U.K. and as to the wider effects of such provisions from the perspective of IFL. The latter question, relating to IFL, is explored in the final chapter. The former question is discussed below.

In Chapter One, it was explained that foreign source income accruing to a resident of a state is generally either not taxed under either the "territorial" basis of taxation (as in Hong Kong) or under the "exemption" method (as in the Netherlands) or subject to tax on a "world-wide" basis but with a credit for foreign taxes suffered (as in the U.K. and U.S.). These approaches to the taxation of foreign source income could not strictly be applied to tax the income of a CFC since such approaches apply only if the taxpayer is initially within the taxing jurisdiction, usually as a result of being resident in the relevant state. The alternative means by which corporate taxation is levied on non-residents is, as has also been explained in Chapter One, according to the basis of "taxable presence" (also referred to as the treaty concept of "permanent establishment"). It will be recalled that, under this basis, a state taxes the income arising within its jurisdiction from activities carried on by a non-resident entity, such as a branch of an overseas company. This basis is also not available to tax the income of CFCs since there is, (it is assumed) no activity amounting to a "presence" in the state of the parent company. Therefore, the widely-accepted bases of taxation, residence and taxable presence, do not in themselves support the taxation of CFCs.

Applying the above traditional concepts of residence and taxable presence it is difficult to avoid the conclusion that, in effect, the CFC provisions represent an extension of the tax jurisdiction of the state enacting the provisions. The CFC provisions are directed against the parent (shareholder) and not the CFC itself (no doubt for reasons for enforceability), so that, from a purely mechanical (or strictly legal) perspective, no taxation is ever levied on the CFC itself. Thus, it is possible to argue that the tax charge is directed against a company resident within the jurisdiction in which the CFC provisions are applied.

However, the reality or substance of the situation is that taxation is exacted on the profits of the CFC, even though this is achieved by the domestic collection mechanism referred to above. In the absence of any official discussion of this, it seems that the CFC provisions represent an extension of the domestic tax base and that there is no adequate nexus (judged by reference to the conventional and widely-accepted approach to taxation discussed in detail in Chapter One) which would justify the tax charge.[57]

Illustrating the point by reference to the established law on the jurisdiction of U.K. taxation, it is clear that the approach adopted to tax the profits of CFCs is at best highly incongruous. There is a significant body of U.K. law dealing with the territorial limits of U.K. taxation.[58]

The decided authorities and the relevant law[59] indicate that the U.K. jurisdiction to tax arises in three situations: where the taxpayer is fiscally resident in the U.K.; where the taxpayer is fiscally present in the U.K. and carrying on trading activities or where income is derived from property situate in the U.K..[60]

In the light of the above, and given that the charge to taxation under the U.K. CFC rules is levied on a resident of the U.K., two alternative conclusions follow. First, it may be accepted that the charge to tax is in reality a charge on the U.K. resident.[61] In this case (and assuming the points made above and the perspective adopted for the purposes of this analysis) the tax charge (which is solely a function of the profits, but not the losses, of an entirely separate overseas company) appears somewhat arbitrary, with no more justification than the levying of a tax charge by reference to, say, the results of the 3.45 at Wincanton.[62] Alternatively, it may be concluded that the tax charge is in substance levied on the overseas company notwithstanding that the tax collection arrangements involve a U.K. company. In this case the imposition of the U.K. tax charge is flagrantly in breach of established principles of the territorial scope of U.K. taxation. (Further, where there is an applicable double tax treaty between the U.K. and the country in

which the CFC is located, the CFC charge may, as noted earlier, represent a unilateral breach of that treaty).[63]

The discussion earlier in this chapter on the assumptions behind the CFC legislation has already noted that it is at least doubtful whether an adequate justification for the CFC legislation has been made by the states enacting such measures. This is on the assumption that there is in fact no nexus of residence or presence (i.e. that the CFC is not resident in the state with the CFC legislation and has not established any taxable presence there). Naturally, either or both of those bases may apply in any particular case. If so, taxation of the CFC would be justified by reference to whichever of those bases applied. However, if a nexus of either residence or taxable presence were to apply, CFC provisions would be irrelevant in any event because other domestic legislation would be available to impose the charge to tax. Since, on this view, the CFC provisions are made otiose by other legislation to the extent that CFCs may legitimately be subject to tax, the necessity for CFC legislation appears questionable. This matter is discussed further below.

THE NECESSITY FOR CFC LEGISLATION

As has been noted, the generally accepted bases of taxation, residence and taxable presence, may in some cases be available to tax to some extent the profits of a CFC.

With regard to the U.K., if a CFC were in fact resident in that state by virtue of the fact that the central management and control of the CFC was exercised in the U.K. (or if the CFC were resident as a result of being a U.K. company)[64] then the world-wide profits of the CFC would immediately become subject to U.K. taxation.[65] If the CFC were not resident in the U.K. but in fact earned some of its profits in the U.K. then such U.K. activity would be likely to establish a taxable presence in the U.K. under general principles.[66] Even if the CFC was neither resident nor had any taxable presence in the U.K., it may still be possible to

effectively tax some or all of its profits by the operation of domestic transfer pricing rules.[67] For example, if the CFC engages in related party transactions with an associate which is either resident or has a taxable presence (i.e. a branch) in the U.K. for tax purposes, the transfer pricing provisions might be applied to ensure that the transfer prices used correspond to market or arm's length rates. Similarly, if a U.K. resident or a U.K. branch of a foreign company negotiated a business transaction and then purported to assign the benefit of the transaction to a CFC associate for no consideration or at an undervalue, the relevant profits would on general principles remain taxable in the U.K..[68]

The position in the case of the U.S. is, broadly, the same as that stated above for the U.K., although the criterion of the residence of a company for U.S. purposes is different, being determined by reference to the country of incorporation alone.[69] This means that artificial arrangements whereby profits earned in the U.S. or the U.K. are imputed to a CFC located in a tax haven can be taxed in the U.S. or U.K. as the case may be without reference to specific CFC legislation.

It is clearly not the case that all powers of the U.K. and U.S. CFC legislation are rendered otiose by other pre-existing legislation. Most obviously, income earned outside the state of the parent (shareholder) company by a non-resident CFC (for example, income earned by the CFC in transactions with other overseas third parties) could not be subject to tax in the state of the parent in the absence of the CFC provisions. However, as noted in the earlier discussion, it is in precisely this sort of situation that there appears to be no acceptable basis or justification for taxation. It is therefore possible to conclude that, to the extent that the CFC provisions are not rendered unnecessary by pre-existing legislation, there remain doubts as to the necessity (and justification) of the legislation.

The process in the U.S. of the enactment of Subpart F did not deal in any detail with the adequacy of existing legislation. The consultative process in the U.K. did, however, briefly touch on the question. In the June 1982 consultative document

the Inland Revenue replied to the argument that existing legislation was adequate to prevent abuse:

> "Those who believe that existing anti-avoidance legislation is adequate are invited to show how it is effective against avoidance through the artificial diversion of trading activities or investment income from the U.K. or where transactions take place between a controlled overseas company and a third party".[70]

The comments already made dispose of the first point in the above quotation: existing legislation and existing principles of taxation (other than CFC measures) will operate to tax income earned in the U.K., but artificially diverted to a tax haven. If the income has not been earned in the U.K., then it is difficult to see by what criteria it can be described as having been subject to any "artificial diversion" from that state. The second point in the above quotation (relating to transactions between a CFC and a third overseas party) is not dealt with by existing legislation. However, in light of the earlier discussions on the assumptions behind the CFC legislation, the almost non-existent analysis of the perceived problem, and the questionable nexus for taxation, it is perhaps rather more reasonable to invite the U.K. Inland Revenue to first show the propriety of what appears to be an extension of the U.K. tax base. The same invitation applies equally to the U.S. Internal Revenue Service or Treasury in the case of Subpart F. Until this is done, the necessity for (and legitimacy of) CFC legislation (whether of the U.S. or U.K. variety) remains in doubt.

CHAPTER 8 - NOTES

1 The reader will be aware that the detail supporting the more general discussion contained in this chapter is set out in Chapters Four to Seven with further relevant background material in Chapters One to Three. The intention behind the discussion in this chapter is to concentrate on those areas which are of fundamental importance from the perspective of IFL but which are relevant to both the U.K. and U.S. CFC legislation.

2 It appears to be irrelevant that Hong Kong, for example, developed its domestic source-based taxation system with a heavy reliance on the deduction of tax at source for the entirely pragmatic reason that such a system seemed to be the only viable means of collecting taxation; or that Cyprus developed as it has largely due to its geographical position which facilitates commercial penetration of the Middle East markets. All these factors are of no relevance in the face of the U.S. and U.K. CFC legislation which simply makes the underlying assumption that all these states are just as much "tax havens" as, say, the island of Sark for the purposes of the CFC legislation. It is of course understood that the U.S. for example, does not, in legislative terms, direct its CFC legislation specifically at any state or set of states, much less at "tax havens". The discussion in the text is concerned not with the legislation itself but with the assumptions underlying the legislation.

3 B. Spitz, Tax Haven Encyclopedia, (loose leaf service), Butterworths, London.

4 In the case of Ireland, for example, there are several well known tax-planning structures which involve Irish companies and these are not by any means restricted to structures which involve Dublin IFSC companies or activities.

5 See discussion in Chapter seven.

6 B.J. Arnold; "The Taxation of Controlled Foreign Corporations: Defining and Designating Tax Havens - II", 1985, British Tax Review, p. 362 at p. 367.

7 For example, during the U.K. consultative process, the Inland Revenue stated that "the need for legislation of some sort to counter tax haven abuse is generally accepted". See Board of Inland Revenue, "Tax Havens and the Corporate Sector, June 1982, para 3. Similarly, as regards the U.S., the entire thrust of the U.S. Gordon Report$_6$ reflects the anxiety on the part of the fisc with regard to the use made of tax havens by U.S. taxpayers - see A Report to the Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division) and the Assistant secretary of the Treasury (Tax Policy), submitted by Richard A. Gordon, special counsel for International Taxation, 12 January 1981. See also Senate Committee Report, 87th Congress, 2d session, s. Rep. No. 1881 (1962) 78.

8 The discussion later in this chapter on the official approach to analysis of the issues provides further evidence regarding the assumption by the tax authorities that the choice of a tax haven location for a company is driven by unacceptable tax avoidance motives.

9 In respect of the U.S., see, for example, a report to The Commissioner of Internal Revenue, the Assistant Attorney General (Tax Division) and the Assistant secretary of the Treasury (Tax Policy), submitted by Richard A. Gordon, Special Counsel for International Taxation, 12 January 1981, passim. In respect of the U.K., see, for example, Board of Inland Revenue, "Tax Havens and the Corporate Sector", June 1982, para 7.

10 See for example, T Clarke and J G Tigue, Dirty Money. (Millington Books, 1975). The book deals with the use of tax havens for the purposes of money laundering and commercial fraud.

11 It is probably true to say that most economists writing on tax would see the objective of raising revenue as the primary objective behind any tax system. See, for example, comments implicit in Adam Smith, "The Wealth of Nations", Book V, Chapter II, Part II.

12 The distinction between raising revenue on the one hand and combatting avoidance on the other has been discussed in detail in Chapter Three.

13 Board of Inland Revenue, "Taxation of International Business; December 1982, foreword, by John Wakeham, M.P.

14 For example, with regard to the "benefit" of deferral it appears to have been assumed that U.S. taxpayers could in many instances simply redirect income otherwise accruing to a U.S. corporation to a tax haven corporation. This is similar to the (implicit) assumption in the official U.K. approach to CFC legislation that taxpayers could easily divert certain types of income to tax havens. The ability of taxpayers generally to divert income in this way is discussed in the main body of the chapter.

15 The President's 1961 Tax Recommendations, reprinted in 1 House Hearings on the Tax Recommendations of the President, 87th Congress., lst session 8-10 (1961).

16 However, it will be recalled from earlier chapters that the official concept of "passive" income is extremely broad and is used, for example, to catch financial trading and similar activities such as securities trading, financing, etc.

17 For example, the existence of minority shareholders in a company which may be part of an international group requires a local "profit centre" approach. Local shareholders, even if a minority, could oppose a transfer of the profits from the company in which they have invested and any

transfer in such circumstances may be an actionable fraud. Even where there are no minority shareholders, market conditions may impose limits to any avoidance schemes. The auditors of the corporate group would be another factor. Since international companies are usually audited by international firms of accountants, they will be subject to an audit with a global scrutiny which requires a proper allocation of income and expenses between the group members. A suitable local "profit centre" approach is often also required to ensure local management morale and performance appraisal and to facilitate the operation of employee bonus schemes. All these factors combine to reduce significantly the ability of top level management to channel income or activities artificially to subsidiaries in tax haven locations.

18 Report of the O.E.C.D. Committee on Fiscal Affairs; Model Double Taxation Convention on Income and on Capital (Paris, 1977) p.91, paragraph 3.

19 With regard to the U.K., see Salomon v Salomon, [1897] AC 22. In the U.S. corporations are accorded separate legal personality under state law. For tax purposes, this characterisation of corporations as legally separate persons is preserved by IRC s.7701 (a) (3), (4).

20 Note 70, Ibid.

21 This point is made by Brian Arnold; "The Taxation of Controlled Foreign Corporations", Taxes International, issue 66, April 1985, p.5.

22 ICTA 1988, s.790.

23 IRC s.902.

24 ICTA 1988 s.790 (4).

25 In the U.K., a resident company is subject to tax on all its profits, wherever arising, under ICTA 1988, s.8. In the U.S., a resident company is subject to tax on its gross income, wherever arising, under IRC s.61.

26 This argument is also referred to by Brian Arnold (see note 21) above.

27 The capital duty charge formerly arose under FA 1973, s.47 (1) and Schedule 19, paragraph 1. The charge was abolished by FA 1988 with effect from 16 March 1988. The charge to tax on world wide profits arises under ICTA 1988, s.8. The network of U.K. double tax treaties is available due to the (assumed) U.K. residence of the subsidiary for the purposes of those treaties.

28 The charge to tax on U.K. income and gains arises under ICTA 1999, s.11 and the network of U.K. double tax treaties is not available due to the fact

that the company which has established a branch in the U.K. will be resident outside the U.K. for the purposes of the U.K. double tax treaties.

29 The point may be illustrated by reference to financial sector inward investment into Japan. As a result of pressure by the Japanese Ministry of Finance, it is extremely rare for such inward investment to be structured using a Japanese company. Instead, a branch structure is typically adopted, being a branch of a Hong Kong incorporated company in a large number of cases.

30 Note 7, Ibid.

31 See Board of Inland Revenue; Taxation of International Business, (December, 1982 pp. 12-16.

32 For example, the U.K. study, which merely lists the types of companies it believes take advantage of tax haven locations, gives no information as to what uses are made by such companies of their retained funds, nor any information as to what percentage of revenues are distributed by way of dividend to shareholders. Without this sort of information, the study does not facilitate the drawing of conclusions on the need for the CFC measures.

33 Note 13 Ibid.

34 See B.J. Arnold; "The Taxation of Controlled-Foreign-Corporations", Conference Report, Taxes International, April 1985, p.3 at p.6.

35 Note 34, Ibid at p.4. The 1976 study was carried out by G. Hufbaver and D. Foster; "U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations; in U.S. Department of Treasury; Essays in International Taxation: (Washington, D.C. 1976).

36 U.S. Department of Treasury; Taxation of the Undistributed Income of Controlled Foreign Corporation, (1976), reprinted in I.B.F.D. Bulletin p.391 at pp 391-2.

37 Submission by the Institute of Directors on the Inland Revenue Consultative Document of January 1981, p.3, 28th June 1981. ICTA 1970, s.482 has now been partially replaced. In its revised form it is ICTA 1988, s.765.

38 It should be stated that the comments in the text on the possible economic consequences of the CFC legislation are inevitably somewhat speculative and clearly far from complete. It is not the purpose or intent of this thesis to offer any specific economic analysis as such of the CFC provisions.

39 See further the detailed discussion contained in the second and third sections of Chapter Nine. A detailed example illustrating the point referred to here is contained in a footnote to the discussion in Chapter Nine.

40 As has been noted in the last chapter, the U.K. Revenue, in responding to representations on the matter, stated that it would not be right to exclude the operation of the CFC provisions merely due to the existence of a double tax agreement; that it would be impractical to revise all double tax agreements and that to terminate them would be too drastic a step. (see Board of Inland Revenue; Taxation of International Business, (December, 1982) pp 22-23). This suggests that the problem was, at least in part, recognised although no proper response is made to it.

41 The analysis in terms of economic substance rather than strict legal form requires no justification in these circumstances and, in any event, is normally a mode of analysis much favoured by the Revenue, particularly in their approach to international tax avoidance.

42 Even if the CFC had a permanent establishment in a state which applied CFC legislation against it, this would not change the analysis. The taxation of the profits of the permanent establishment would of course be fully justified on normal principles but this would be irrelevant to the operation of CFC legislation.

43 Although the domestic rate of tax is comparatively high (20%) it is well known that there are privileged regimes which apply to certain companies, resulting in a very much lower tax charge: for example, the "exempt company" regime under the Income Tax (Exempt Companies) Act 1984 which involves an annual tax charge of £250 or the non-resident company regime (annual tax charge £450).

44 For instance, a good recent example relates to the "commensurate with income standard" to be applied to royalties and other intangibles as a result of TRA 1986 amendments to s. 482 of the Internal Revenue Code. These "superroyalty" provisions as they are known, require periodic adjustment of transfer prices under domestic law.

45 The approach referred to in the text is not, however, unique. As has been discussed in Chapters Four and Six, there are in the U.S. and U.K. various measures which tax in the hands of shareholders the undistributed income of a company. For example, the FPHC legislation in the U.S., as discussed in Chapter Four, and the provisions in ICTA 1988, s. 739, directed against the transfer of income abroad by an individual, as discussed in Chapter Six.

46 The comparison is not entirely straight forward because although there are some states in which domestic transfer pricing provisions are applied consistently to increase or reduce taxable profits (as appropriate) it is by

no means always the case that domestic transfer pricing legislation will have an entirely symmetrical treatment and only some double tax treaties provide for symmetrical treatment where the associated enterprises article applies.

47 For example, the informal capital doctrine under Dutch tax law illustrates the principle that, under Dutch law, transactions between a company and its shareholders, in so far as these are not at arm's length, should not have an influence on determining the taxable profit of the company. The informal capital doctrine has been developed by Supreme Court case law and in essence constitutes the "mirroring" position of a deemed distribution to a shareholder. Where, for example, a subsidiary sells an asset to its parent below market value then, in principle, the difference between market value and transfer value gives rise to a recognition of a taxable profit that is regarded as instantly distributed on a net basis. Where the situation is reversed, i.e. a parent distributes an asset at a value below its market value, then the difference between the market value and the transfer value is taken into account as well. This is done through the informal capital doctrine which would result in the subsidiary recording the asset it required from its parent at market value. The difference between market value and transfer value does not constitute a profit but is regarded as informal capital. See further H.R. April 3, 1957, BNB 1957/165 and H.R. May 31, 1978, BNB 1978/252. In the latter case, an interest free loan from a Swedish ultimate parent company to its Dutch subsidiary company was regarded as constituting an informal capital contribution for an amount equal to the arm's length rate of interest. Thus, without actually having to pay the interest, the Dutch company could nevertheless accrue an account for an interest charge in its books for tax purposes.

48 Of course it is not suggested that the situation described in the text - 10% shareholders not being aware of each others existence - is a situation which will be common. However, if this is correct, then it would not seem necessary for the legislation to deal with the situation in the way it does.

49 ICTA 1988, s.747 (1).

50 Note 36, Ibid, p.434.

51 IRC, s.954.

52 The U.K. motive test is contained in ICTA 1988 s.748 (3). The requirement that a direction be given before the legislation can apply is to be found in ICTA 1988, s.747 (1).

53 President's 1961 Tax Recommendations, reprinted in 1 House Hearings on the Tax Recommendations of the President, 87th Cong. 1st sess. (8-10) 1961, at pp.27-28.

54 Board of Inland Revenue; "Taxation of International Business", December 1982, foreword.

55 For example, an International Fiscal Association Seminar Paper records the following comments on the effect of the French CFC provisions which are contained in Article 70 of the Code General des Impots: "It may be feared that the system organised under Article 70 is of a nature to jeopardise French enterprises on the international market, the more so as it extends as well to international joint ventures since an interest of 25% is enough to make the French taxpayer subject to Article 70". Section on France by J.C. Goldsmith, "Recourse to Tax Havens, Use and Abuse", IFA Seminar Paper (Kluwer, 1980), p.47.

56 In the U.K. the question of the legitimacy of the taxation of CFCs was hardly discussed at all by the Inland Revenue papers, although the issue was raised by a small number of the respondents to the consultative papers, such as the Institute of Directors. In the U.S., there is no apparent record of discussions on the legitimacy of the measures although subpart F was pronounced to be within the constitution in the case of Garlock Inc. v. Comr 58 TC 423 (1972), affirmed 489 F.2d 197 (2nd Cir. 1973).

57 In this context it should be noted that a major focus of debate on IFL has been the question whether there are limits to the jurisdiction of a state to levy tax imposed by general international law. That debate (including references to the works of Norr, Knechtle, Qureshi and Akehurst), and its relevance to this thesis is discussed in Chapter One under the heading "The substantive enactments which constitute IFL". A more recent article on this same subject which provides a helpful summary of the main issues is D. Martin, "Extraterritorial Enforcement of Tax Law", Journal of Asian Pacific Taxation, May/June 1992, p.11.

58 For example, the general principle is stated by Lord Herschell in a well-known statement in Colquhoun v. Brooks: "The Income Tax Acts, however, themselves impose a territorial limit; either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there" (2 TC 490 at 499). Other leading U.K. cases, such as Clark v Oceanic Contractors Inc [1983] STC 35 and National Bank of Greece v Westminster Bank Executor and Trustee Co. (46 TC 472) are fully in accord with this general principle.

59 ICTA 1988, ss.6, 8, 11.

60 This explains the significance of the extensive body of U.K. law dealing with such matters as where the situs of assets is for these purposes - see, for example, New York Life Insurance v. Public Trustee ([1924] 2 Ch.101) on the general rules for determining the situs of debts under English law.

61 In this case, the approach to the tax charge would follow that adopted in earlier measures in both the U.S. and the U.K. such as the PHC or FPHC rules in the U.S. or the "close company" rules (ICTA 1988, ss. 423-429 as repealed by FA 1989, Schedule 12 para 1(b)) or the rules directed against transfers of income abroad (ICTA 1988, s. 739), which have been enacted in the U.K..

62 It may be argued that the tax charge is not as arbitrary as the example suggests because the charge is referable to the relevant profits of the CFC. In this case the wide range of consequences considered in the text which flow from such a tax charge would represent a number of problems which would have been ignored in imposing that tax charge.

63 This is not a point which is in practice accepted by the U.S. or U.K. tax authorities as they will not accept that the "business profits" (or other) article of a treaty precludes taxation under the CFC provision.

64 FA 1988, s. 66.

65 ICTA 1988, s. 8.

66 ICTA 1988, s. 11.

67 ICTA 1988, s. 770.

68 This is because the profits would have been earned in the U.K. and any attempt to "export" them at undervalue could be blocked by an application of the U.K. transfer pricing legislation of ICTA 1988, s. 770.

69 See Internal Revenue Code Regulations, Reg. s. 301 7701-5. The U.K. test of residence is determined by reference to the location of central management and control and now also by reference to whether or not a company has been incorporated in the U.K. (F.A. 1988, s. 66).

70 Board of Inland Revenue, "Tax Havens and the Corporate Sector", June 1982, para 6.

CHAPTER 9

CONCLUSIONS ON THE CONSEQUENCES FOR INTERNATIONAL FISCAL LAW OF UNILATERAL ANTI-TAX HAVEN LEGISLATION

INTRODUCTION

This thesis is concerned with the likely consequences for IFL, and the development of IFL, of unilateral anti-tax haven measures. In attempting to evaluate those consequences it has been necessary to consider (in part A) the nature and scope of IFL (and, particularly, the primary objective underlying IFL and its policies and principles) and the concepts which are fundamental to any discussion in this area, namely the concepts of international tax avoidance and tax havens. Parts B and C of this thesis have been concerned with the unilateral anti-tax haven legislation itself, taking the legislation of the U.S. and the U.K. respectively as illustrative examples.[1] Having drawn certain conclusions on that type of legislation in the last chapter, (and on the basis of the discussion in the preceding eight chapters) it is now possible to proceed to the conclusions which may be drawn on the fundamental issue underlying this thesis, namely the likely consequences for IFL, and the development of IFL, of unilateral anti-tax haven legislation.

This chapter is organised into five distinct sections.

The first section, dealing with the consequences of the unilateralist approach, draws conclusions on how an issue (such as the approach to the taxation of CFCs) which is of major importance to IFL should best be considered. Having regard to the earlier discussion in Part A of this thesis (particularly that contained in Chapter One), it would be expected that a multilateral approach would be required. The first section considers some of the consequences of the failure to adopt a multilateral perspective, looking at the results that are produced by the unilateralist approach.

The second section of the chapter is given over to concluding on some of the major effects or consequences of the CFC rules and includes a discussion on the relationship of the CFC rules to the policies and principles of IFL and to the

provisions of double tax treaties. Consideration is also given to the effect of CFC legislation on low or no tax states.

The third section of the chapter deals with the degree to which the CFC rules contribute toward the realisation of the primary goal underlying IFL, namely the removal of fiscal distortions to the freedom of movement of capital and persons and the exchange of goods and services, particularly in relation to the phenomenon of international double taxation.

The discussion in the fourth section of the chapter is directed at conclusions on the economic basis for CFC legislation in the light of the earlier discussions in Chapter Two and the section also draws some conclusions on the complexity of CFC legislation and the likely effect of this.

Finally, the fifth section of the chapter concludes the discussion in Part D of this thesis with some overall conclusions and observations on the consequences for international fiscal law of unilateral anti-tax haven legislation.

CONSEQUENCES OF THE UNILATERALIST APPROACH

As has been discussed in Chapter One, international tax measures may be developed unilaterally, bilaterally or multilaterally. The first matter to be discussed in this chapter is the approach adopted by the U.S. and the U.K. fiscs to the perceived problem created by the existence of CFCs located in tax havens, i.e. the unilateralist approach.

It must be noted at the outset that a state may not always have the ability or opportunity to pursue fiscal policy on a multilateral (or bilateral) footing to the same extent as a unilateral route. For this pragmatic reason, even if a multilateral approach is generally regarded as preferable on theoretical grounds, the use of a unilateral route to deal with a particular issue is not in itself necessarily grounds for criticism. Nonetheless, it must also be borne in mind that the relative

importance of an issue will also be of significance in determining how it is dealt with: where an issue is clearly of major significance and raises fundamental matters of principle in terms of the policies and principles of IFL, it is to be expected that it will receive appropriate treatment.

As is now evident from the discussion in earlier chapters, any approach to the taxation of CFCs raises a number of fundamental issues of IFL. For this reason it would seem hardly tenable to argue that, due to the relative insignificance of the matter, discussions on the treatment of CFCs could not be accommodated on a multilateral agenda. Indeed, other issues discussed recently by such organisations as the O.E.C.D. Committee on Fiscal Affairs (which is arguably the most influential of multilateral forums) emphasise this point. That committee has recently been considering in some depth the subject of the taxation of entertainers, artistes and sportsmen and has now prepared a report on the subject.[2] Whilst this subject is of some international importance, it is submitted that the issues involved do not compare in terms of breadth, complexity or significance with those raised by the measures designed to tax the profits of CFCs located in tax havens.

For the above reason, the CFC provisions are a prime candidate for multilateral discussion and, if appropriate, for concerted multilateral action. However, there has, until very recently, been no such discussion nor any suggestion by the fiscs concerned that a multilateral approach should be considered. The 1987 O.E.C.D. report entitled "Tax Havens : Measures to Prevent Abuse by Taxpayers"[3] may perhaps be interpreted as a modest correction of the position, although that report, which is referred to further below, contributes relatively little to the subject and wholly fails to discuss the issues which are identified in this thesis as of most fundamental relevance to IFL (particularly in relation to the policies and principles of IFL).

It should be acknowledged that at the time of the enactment of Subpart F in 1962 no credible multilateral vehicle existed for this purpose.[4] This position has since

changed and it is therefore somewhat surprising that the U.K. fisc, during 1981 to 1984, appears not to have considered taking up the issue on a multilateral basis.[5] Similarly, Canada (in 1972), Germany (also in 1972), Japan (in 1978) and France (in 1980) have all adopted CFC measures without pursuing any form of bilateral or multilateral approach. The reasons for this are not immediately clear. In the absence of any published explanation it is only possible to speculate as to what these reasons may be. In view of the fact that the various tax authorities perceive the problem as being one of a leakage of domestic tax revenues[6] it is possible that the problem is perceived as being of an exclusively national interest, rather than being a problem raising fundamental international issues relating to fiscal law. In the light of the discussion so far in this thesis, such a view would appear misconceived.[7] Alternatively, the perception that a leakage of revenue resulted from the existence of CFCs located in tax havens may have prompted these states to act unilaterally on a self-interested basis, disregarding as comparatively unimportant considerations of IFL. In this case, such action would not merely run counter to the development of the policies and principles of IFL but may also be counter to the best interests of the state concerned, both in terms of its international standing and its attractiveness to foreign investors.[8]

Another possibility is that there may be some reluctance on the part of the fiscs concerned to take up the issue in a multilateral forum due to the slower pace the discussion would inevitably take. (It is, after all, generally acknowledged that business in international committees and similar institutions is conducted comparatively slowly). However, there are sound reasons why progress in dealing with the problems raised by the taxation of the profits of CFCs may be relatively slow where some form of multilateral institution is concerned: the existence of a number of participants (from a variety of states) in the discussion would be more likely to lead to consideration of all the problematic issues which the unilateralists have so far failed to deal with adequately (if at all); namely the justification for the apparent extension of the tax base; the criteria by which the appropriate type of international tax avoidance activity is recognised; the concept of a tax haven;

the effect of CFC measures on the sovereignty of the "tax haven" to levy tax according to its own fiscal system; etc.

As has been demonstrated in the case of the U.K. and the U.S. these problematic issues have not been treated with anywhere near the requisite degree of thoroughness and, effectively, a number of key issues of IFL have been virtually ignored in the unilateral enactment of CFC legislation.

One further unwelcome consequence of the unilateral character of CFC legislation is the tendency on the part of states enacting CFC measures to legitimise the legislation by citing other countries which already have similar CFC measures.[9] Although the fact that other countries have CFC measures may be of relevance in any discussion of proposed CFC measures, it remains the case that the number of countries not having CFC legislation is massively superior to those that do.

The tendency to cite the CFC measures of other states in support of the enactment of CFC legislation should be discouraged because it imparts an apparent (but unjustified) legitimacy to the particular measures being discussed and it consequently impoverishes the analysis of any particular proposal.[10]

The chief danger arising from the above is that defective legislation may be enacted by a state as a result of the "importation" without proper analysis of foreign approaches to a particular issue.[11]

This is of particular concern in the context of CFC measures because of the fundamental issues of IFL raised by the enactment of that legislation. Unfortunately, as a result of the above process, these issues are receiving wholly inadequate attention and are arguably almost ignored by the fisc enacting the unilateral CFC legislation. In those circumstances, it does not seem unreasonable to assume that a multilateral discussion would improve the overall quality of the analysis of such measures.

In view of the above comments it might have been expected that the O.E.C.D. paper referred to earlier (entitled "Tax Havens : Measures to Prevent Abuse by Taxpayers")[12] would have provided a more analytical review of the problems associated with unilateral measures directed against tax havens. Unfortunately, that paper is somewhat disappointing in this (and most other) respects. There is in the report hardly any discussion of any of the issues identified in this thesis to be of crucial significance to IFL.[13] Instead, the detailed sections of the report are concerned with a (reasonably familiar) discussion of the characteristics and use of tax havens: an overview of relevant anti-avoidance legislation; experience of that legislation and options for international co-operation. The possibility of a multilateral approach is canvassed in the last section of the paper, but this is in connection with an international exchange of information and administrative assistance, rather than a multilateral consideration of the fundamental issues relating to IFL which are raised by the CFC legislation.

The O.E.C.D. report therefore appears to have accepted without question the implicit assumptions behind unilateral CFC legislation.[14] In view of the composition of the membership of the Committee on Fiscal Affairs, it is perhaps not surprising that such assumptions have been readily (and uncritically) adopted. The prior existence of unilateral CFC measures in a number of developed states will inevitably have some impact in guiding the approach taken by a multilateral committee of tax officials. In this respect, it would appear that the influence of existing CFC legislation not merely reaches other states in the manner described earlier but also shapes the multilateral discussion by tax officials of the use of tax havens. For all the reasons stated earlier, this influence, which appears to ignore some basic questions of IFL, is clearly not in the best interests of IFL.

The earlier comments may suggest that unilateral action in the field of IFL is always to be deprecated. However, no such suggestion is intended and there is no reason why, at least theoretically, appropriate unilateral measures could not be in the vanguard of the development of IFL. Nonetheless, the available empirical evidence does not generally support the use of a unilateral approach as a means

of developing issues of IFL. This is probably a result of the tendency of a fisc to act in a very self -interested manner when it acts in isolation (a tendency referred to briefly in Chapter One). Moreover, from a practical perspective, it is difficult to see how IFL can be developed effectively other than by a multilateral approach. This international approach is implicit in the primary objective underlying IFL (namely, the removal of fiscal distortions to the free movement of capital and persons and the exchange of goods and services) particularly as that primary objective is usually interpreted in the context of cross-border movements and exchanges. However, as the earlier discussion (especially that in Chapter One) has also shown, an international approach is also a vital component in shaping the policies and principles of IFL and the pre-substantive patterns of IFL as these all involve international issues or problems of fiscal law. As such, it is arguable that the only proper response to their development is an international approach.

For all the above reasons, some conclusions on the unilateral approach adopted towards the taxation of the profits of CFCs can now be drawn. First, a unilateral approach to matters of IFL is from an empirical perspective likely to be unhelpful per se to the development of IFL in comparison with a multilateral approach. Second, due to the self-interested motives behind a strictly unilateral approach to problems of IFL, legislation enacted with regard solely to unilateral considerations may often be difficult to reconcile with the policies and principles of IFL (this point is revisited below in the discussion of international double taxation). Third, progress in the development of IFL may be impeded by the existence of unilateral measures of the sort discussed above. This conclusion is suggested by the above discussion and substantiated in further detail below in the discussion relating to the wider implications of the CFC provisions.[15]

WIDER IMPLICATIONS OF THE CFC PROVISIONS

It has been stated that progress in the wider development of IFL may be impeded by the existence of such unilateral measures as the CFC provisions. This proposition will now be considered further in relation to three areas:

1. The accepted "nexus" for taxation.
2. The impact of CFC provisions on double tax treaties.
3. The position of low tax states in the development of IFL.

1. The Accepted "Nexus" for Taxation.

It was explained in Chapter One that some of the more developed principles underlying IFL concern the "nexus" that is required to exist before one state may tax a company which is a resident of another state. In the last chapter it was suggested that the taxation of CFCs is not easily reconcilable with the application of either of the widely accepted principles of taxation; residence and taxable presence.

Of course, it may be that exceptions to the principle that taxation is to be levied by reference to residence or taxable presence can be justified. However, if such exceptions to those principles are claimed, it would certainly be necessary to substantiate the reason for the existence of the exceptions. In view of the discussion in the last chapter, it remains doubtful whether either the U.S. or the U.K. has established (or even attempted to establish) the existence of any acceptable nexus which justifies the imposition of taxation by means of CFC legislation.

This is an important point since, in developing a generally accepted approach to, or set of principles on, the nexus required before a state may seek to exercise its taxing powers, significant progress is being made toward eradicating the phenomenon of international double taxation and toward creating a more certain

fiscal environment which in itself is conducive to securing the primary objective underlying IFL. The importance of this wider point seems to have been overlooked in the enactment of both the U.S. and U.K CFC legislation, although it is given substantial support by the tax authorities of those countries in other contexts, making the omission in the case of the CFC legislation all the more remarkable.[16]

Prima facie, since companies are subject to tax under CFC rules without justification according to the accepted principles of residence and taxable presence, the risk of double taxation is increased.[17] If states levy taxation without having first demonstrated how that the method of taxation adopted conforms to an accepted basis or nexus of taxation, then such a development may undermine seriously the development of the principles and therefore also the policies and primary objective underlying IFL. If such a development became widespread, the climate for co-operation between states in connection with matters of IFL would not be favourable. There would be less common ground between states and the prospect for international agreements or co-operation would be diminished.[18]

It is therefore considered that if states individually begin to adopt measures which are perceived as unjustified or contrary to the accepted principles, policies and primary objective of IFL (and it is suggested that the enactment of unilateral CFC measures is more rather than less likely to lead to such a development) then the prospects for the beneficial development of IFL (in its broadest sense) are thereby reduced.

There are two further immediate dangers arising from the unilateral taxation of CFCs in the case where an acceptable tax nexus has not been established. First, there would appear to be some increased danger of international double taxation. This matter is discussed in a separate section later in this chapter. Second, there are potentially adverse consequences as regards the position of low tax states in the development of IFL. This matter is also specifically addressed later in this chapter.

2. CFC Provisions and Double Tax Treaties

The relationship of the CFC provisions to existing double tax treaties was considered in the last chapter. It is now necessary to proceed to evaluate the consequences of the position in terms of the development of the policies and principles of IFL.

The fact that the CFC provisions seem to have been enacted with no official consideration of their relationship to double tax treaties and apparently contradict the provisions of such treaties is likely to have the effect of undermining confidence in, and therefore reliance upon, such treaties.[19] Where legislation is passed unilaterally which contradicts the provisions of existing double tax treaties, the entire purpose of the double tax treaty concerned is destroyed. As noted in Chapter One, a comprehensive double tax treaty represents the agreed allocation of taxing rights between states. If one state subsequently enacts legislation which has the effect of contradicting that allocation, the treaty is to that extent rendered redundant. This undermining of confidence in treaties affects both taxpayers and other fiscal authorities since taxpayers will become more hesitant in relying on the provisions of double tax treaties and fiscal authorities may take the view that existing treaties are unlikely to be respected by co-signatories. It is also a significant impediment to the future development of IFL, the principles of which have, as explained in Chapter One, been so far largely developed through the medium of double tax treaties.

This development is particularly to be condemned in view of the efforts which have sought, over the past twenty years or so, to create internationally acceptable model tax treaties - or pre-substantive patterns of IFL - (such as the O.E.C.D. model double tax treaty) as a means of reducing international double taxation and increasing international co-operation in tax matters. In this respect the objectives of the pre-substantive patterns of IFL run parallel to the principles of public international law. Article 26 of the Vienna Convention on the Law of Treaties (a codification of the observed principles of customary public international law)

reiterates the internationally accepted rule that each contracting state is bound to perform and observe the obligations it has assumed in the relevant treaty.[20] In consequence, unilateral measures which are counter to those obligations constitute a breach of public international law.

In addition to the damage done generally to the institutional status of double tax treaties, the unilateral abrogation or overriding of treaty measures may also adversely affect the state concerned. This may result either from foreign taxpayers being discouraged from making investments in that state or from foreign states becoming unwilling to enter into double tax treaties with that state. In either case, economic damage to the state concerned may be sustained.

The above discussion leads to an additional reason why the strictly unilateral route adopted in the case of CFC legislation may be comparatively unhelpful. In Part B of this thesis, the development of Subpart F since its enactment in 1962 was briefly surveyed. It is evident from that discussion that there appear to have been various different intentions of policy behind Subpart F during its life on the statute book to date. These changes of policy are probably the inevitable consequence of varying fiscal policies adopted by the governments of the day.

However, they do suggest that in practice CFC legislation may be constantly modified or shaped to suit a current fiscal policy. Such changes in policy are obviously frustrating to the taxpayer when purely domestic tax law is involved. In the case of measures affecting the taxation of overseas transactions or arrangements, such changes have the more serious potential to cause international double taxation, in addition to creating an unstable environment for international trade and investment. This is in itself a reason generally to prefer that substantive tax provisions which affect international transactions should be produced as a result of multilateral collaboration and the application of agreed principles of IFL, since this would probably lead to the production of more clearly defined fiscal objectives and measures which are less prone to be varied unilaterally.[21]

3. The Position of Low Tax States in the Development of IFL

One of the questions raised in Chapter Three was the role of low tax states in the development of IFL in its broadest sense.[22] The discussion concluded that the development of IFL would be considerably assisted by the participation of such states in the development and formulation of the policies and principles of IFL. However, legislation of the type exemplified by the CFC legislation of the U.S. and the U.K. does little to promote such participation and is likely to lead to the creation of attitudes of hostility on the part of those states in which CFCs subject to the provisions are located. There are two reasons why CFC legislation is likely to lead to such hostility.

First, the CFC provisions are blatantly engineered to be "anti-haven" legislation. As such, they amount, in fiscal terms, to an economic attack on tax havens. This result might be mitigated if a sound argument (or arguments) had been made to justify the provisions by reference to accepted principles of IFL. In the absence of such an argument, the CFC provisions may well be interpreted by low tax states as a punitive measure directed against the mere use, for whatever reason, of a low tax state. Such an interpretation seems fully justified in the context of official pronouncements on the matter. For example, in the Gordon Report (to which reference has already been made), various measures are advocated to isolate "abusive" tax havens (which are described as states which do not co-operate by providing full information required by the U.S.). The purpose of such measures is stated bluntly to be "to discourage U.S. business activity in the tax haven".[23] In the Report, the perceived interests of the U.S. are regarded as paramount and the rights and sovereignty of the tax haven states are completely ignored or overridden. This indicates that the U.S. approach to those states is highly self-interested, an attitude which is hardly likely to generate an atmosphere of trust and co-operation between the states involved.

A second reason why hostility may be generated is that, despite the mechanism adopted for the collection of tax, the CFC provisions amount in substance to a tax

charge levied on the profits of the CFC itself. Therefore, low tax states may interpret the CFC measures as amounting to an extension of the jurisdiction of overseas fiscs at their expense. Arguably, CFC provisions are in effect equivalent to sending tax collectors from overseas fiscs into the jurisdiction of the states in which CFCs are located. On this view, low-tax states will no doubt consider such legislation an affront to their fiscal sovereignty. Again, the lack of any apparent justification for the CFC measures does little to suggest that the infraction is other than arbitrary.

In view of the discussion in the last chapter it is not a tenable counter-argument to propose that the tax charge is not directed at tax haven companies because the tax is collected from their parent companies located in the territory applying the CFC legislation. It is not possible to comment with any authority on the reaction to, or perception of, the CFC measures on the part of low tax states since there appears to have been no public comment by any such state as to its attitude to these provisions. However, on the basis of the above discussion (and the general discussion in Chapter Three) it is perhaps reasonable to form the tentative conclusion that the two factors referred to are more, rather than less, likely to provoke hostility on the part of low-tax states and further remove such states from the process of development of IFL.[24]

DOUBLE TAXATION

The question of international double taxation is of primary relevance in the context of this chapter and goes to the heart of the primary objective underlying IFL since it will be recalled from Chapter One that the main concern in the context of the discussion of that primary objective is the phenomenon of international double taxation. As explained in the earlier discussion in Chapter One, international double taxation is conventionally classified into juridical and economic international double taxation; juridical international double taxation arising where the same income (or capital) is taxed twice in the hands of the same taxpayer and economic international double taxation arising where the same

income (or capital) is taxed twice in the hands of taxpayers who are legally separate persons but who, from an economic perspective, are identical or closely associated.

International double taxation may result from the operation of the CFC provisions although it is not clear if the double taxation is more correctly viewed as juridical or economic.

Double taxation arises because the fiscs of both the U.S. and the U.K. fail to make any allowance for the fact that the jurisdictions against which their CFC legislation is chiefly directed raise the majority of their corporate tax from non-income based taxes. (For example, in the case of the Cayman Islands, revenues are raised chiefly by stamp duties and licence fees). Although the U.S. and the U.K. CFC provisions permit double tax relief for overseas local taxes suffered by the CFC, this relief is restricted to income based taxes and no account is taken of stamp duties, licence fees and the like.[25] The effect of this is that overseas subsidiaries subject to CFC provisions are taxed by reference to the approach adopted by their local fiscal jurisdiction and are also in effect taxed according to the approach adopted by the fisc in the state in which their parent is based.[26]

It is submitted that this is a clear case of international double taxation although, as noted above, it is not immediately clear that the circumstances fall into either the juridical or economic category of international double taxation. The situation is not easily viewed as juridical international double taxation because, strictly, it is not the same taxpayer on both occasions: the foreign subsidiary is taxed by stamp duties and licence fees and the parent is taxed, as a result of the "transparency" effect of the CFC provisions, according to the income-based approach of its domestic fisc. Neither is the situation clearly a case of economic international double taxation. It is true that the taxpayers are in most cases economically identical, despite being legally separate. However, before conventional economic international double taxation is found to be present, it must also be the case that the same income (or capital) is taxed twice. Since one

form of taxation (in the state of the parent) is levied by reference to income and the other form of taxation (in the state of the subsidiary) is levied on the quite separate bases of executed documents (in the case of stamp duties) or licences granted (in the case of licence fees) it is not clear if the same income (or capital) is taxed twice.[27]

However, the above difficulties arise as a result of the unsatisfactory nature of the conventional classification (and explanation) of international double taxation and they should not be taken as meaning no double taxation has occurred. The case for the existence of international double taxation in the circumstances under discussion is founded on the fact that the consequence of the operation of the CFC provisions is quite clearly that the foreign operation concerned is subjected to the basis of taxation adopted in both its local tax jurisdiction and also in the tax jurisdiction of its parent.

Of course, in many cases the extent of the international double taxation which arises as a result of the circumstances discussed above is relatively modest, due to the low level of taxation in states such as the Cayman Islands against which CFC legislation is directed. However, the existence of the point is to be noted for two significant reasons. First, as discussed in detail in Chapter One, the objective to remove international double taxation is almost inextricably bound to the goal of achieving the primary objective underlying IFL, namely the removal of fiscal distortions to the free movement of capital and persons and the exchange of goods and services.[28] Yet this is an instance of international double taxation (even if of modest proportion) being created as a result of the implementation of CFC provisions. Second, so far as can be ascertained, no acknowledgement of the different approach to taxation adopted by countries such as the Cayman Islands (and other countries against which the CFC provisions are in general directed) has ever been made in the formulation, enactment or administration of the CFC provisions, whether in the U.S. or the U.K.

Both the above matters taken together further corroborate the points already made in connection with the unilateralist approach adopted by the U.S. and the U.K. to the perceived problem. This further emphasises the necessity of a wider discussion and a more analytical examination of the activities to which objection by the fisc is taken.

A potentially more serious consequence of the CFC legislation is the possibility of it creating a triple charge to taxation. An example may illustrate the point. It is assumed that a Cayman Islands company, which is a wholly owned subsidiary of a U.K. company bears, say, an aggregate 5% tax cost in the form of stamp duties, licence fees and the like on its profits, which are derived from certain related-party transactions. It is further assumed for the sake of the example that the U.K. company is a wholly-owned subsidiary of a U.S. company and does not derive profits from any activities or transactions caught by Subpart F. The structure outlined will lead to the Subpart F rules applying to the profits of the Cayman company with the result that those profits will be subject to U.S. tax at the rate of 34%. Where a direction is given by the Board of Inland Revenue, the same profits will also be subject to U.K. taxation at the rate of 35%.[29] The total tax charge is therefore in the order of 69%.[30] Given the significant amount of takeover and merger activity involving U.S. and U.K. groups of companies, the example reflects a situation which is likely to arise in practice. In such an instance the obvious solution is to transfer the shares in the Cayman company to the U.S. company, although this may well involve a string of other tax issues or difficulties.[31]

The major point illustrated by the example, however, is that such difficulties will almost inevitably arise when anti-avoidance legislation aimed at international transactions or arrangements is enacted unilaterally without regard to the accepted principles of IFL. The U.S. CFC legislation makes no provision for the U.K. legislation (and vice versa) because both sets of legislation represent self-interested attempts by the U.S. and U.K. fiscs to maximise their revenue irrespective of the dictates of the policies and principles of IFL.[32]

ECONOMIC ASPECTS

Economic considerations have been raised on two previous occasions in this thesis. In Chapter Two it was suggested that the phenomenon of international tax avoidance cannot be understood without an adequate investigation into its economic characteristics and effects. The same is also true, it was suggested, of anti-avoidance legislation. In the last chapter, the official economic analysis relating to the U.S. and U.K. CFC measures was considered and found to be somewhat inadequate, particularly in the case of the U.K.

The problem of the lack of proper economic analysis goes to the heart of much anti-avoidance legislation and it is certainly not a problem connected with CFC legislation alone. This is well illustrated by a recent O.E.C.D. report on thin capitalization.[33] No part of the thirty-six page report is given over to anything remotely approaching an economic analysis of the perceived problem. The long discussion on what anti-avoidance measures may be applied by the fisc is preceded with the mere statement:

> "Faced with the fact that the use to loan financing rather than equity financing may have consequences for tax revenue, those concerned with tax policy may have to consider a variety of factors in deciding what, if any, action should be taken in relation to particular cases of the use of loan financing" (emphasis added).[34]

Whereas the first possibility (that the use of loan financing rather than equity financing may have consequences for tax revenue) is then completely ignored in the paper, the second possibility (that those concerned with tax policy may have to consider appropriate action) is fully explored on the assumption anti-avoidance legislation is needed. Countless other instances of the complete failure to consider economic issues when discussing anti-avoidance legislation could equally be mentioned. In other instances where an attempt at an analysis is attempted, the

attempt is usually so partial or so superficial that it can hardly be taken seriously. In another O.E.C.D. publication, for example, it is concluded that:

> "The foregoing considerations indicate that although measures against international tax avoidance have traditionally been justified in purely fiscal terms, the need to stop a tax loss to national treasuries, there are also strong economic arguments to support governments' actions"[35]

Singled out as one of these "strong economic arguments" is the existence of the competitive advantage enjoyed by multinational enterprises over purely domestic businesses as a consequence of increased opportunities for avoiding tax, for example as a result of their ability to use base companies.[36]

The document in question appears to assume an exact equivalence between purely domestic businesses and international businesses. It therefore evidences no grasp of any theoretical understanding of the economic basis of the multinational corporation and equally ignores the possibility that the same legitimate economic advantages that accrue to international (as compared to purely domestic) businesses may also be relevant in the sphere of taxation.[37]

It is an advantage of an international business that there may be available a choice as to how the business is structured and a choice as to which location should be adopted for certain activities. These choices may amount, directly or indirectly, to choices between tax jurisdictions and such choices are obviously not available to businesses located in a single country. However, this does not in any way suggest an improper or unfair state of affairs but merely reflects fundamental economic differences between domestic and international enterprises. In spite of the unsupported assumption to the contrary (which is implicit in the official approach referred to above), it is considered that the availability of these choices to international businesses cannot be described as a "strong economic argument" for anti-avoidance legislation.

The poor quality of analysis generally is to be deprecated particularly strongly in the case of the CFC legislation due to the very significant issues of IFL which are involved, since it is precisely in such circumstances that the benefit of an economic analysis would be of use. Indeed, the lack of economic analysis in the case of the CFC provisions exemplifies the complete lack of such analysis more generally.

In all the official U.S. and U.K. documents considered earlier in this thesis, it is assumed without question that the existence of CFCs must, in the absence of anti-avoidance legislation, lead to a loss of revenue for the state in which the parent company (or shareholder) is located. It would also appear to be assumed that by preventing such "avoidance" opportunities, the fisc will increase the amount of tax collected generally.[38]

These assumptions about the impact of CFCs should be tested by empirical investigation and analysis. A relatively sophisticated economic analysis would be required before conclusions on the economic effect of untaxed CFCs and on the effect of anti-CFC legislation could be drawn. As has been suggested earlier in this thesis, such an approach to analysis is particularly needed in view of the doubt that surrounds certain conventional assumptions on the economic function and necessity of anti-avoidance provisions. For example, if the ideas propounded by Dr Bracewell Milnes (discussed in Chapter Two) are correct (or even if only the basic distinction which is made by Bracewell Milnes between raising revenue on the one hand and fighting avoidance on the other is correct), this should have a potentially enormous effect on the entire approach to the subject of tax avoidance.

For present purposes, the point to be emphasised is that, to the extent CFC and other anti-avoidance provisions are founded on economic assumptions as to loss of tax revenue, they (and the perceived problems against which they are directed) should be subject to proper economic analysis. Regrettably, such analysis is almost completely lacking on both a domestic and international level.

One of the basic impediments to the use of sophisticated economic analysis is the traditional approach of the tax authorities in any particular state. The basic ethos of the tax authority is to ensure taxpayer compliance and to prevent or minimise avoidance and evasion of tax. Wider questions relating to tax yield, the economic impact or commercial considerations are at best subordinated to these primary goals and at worst not even recognised.[39] It is therefore to be expected that tax authorities will seek legislation which will give them the means to achieve their immediate goals more easily, perhaps without enquiring too closely into the wider implications of such legislation. It is submitted that the CFC provisions of the U.S. and U.K. (inter alia) represent an example of this tendency.

An obvious consequence of the attitude taken by tax authorities is that potential legislation promoted by those authorities is likely to be primarily of an anti-avoidance character. Therefore, if it is accepted that the wider matters referred to above should be reflected in such legislation, it may not always be advisable to rely solely on the domestic tax authority for the preparation and framing of legislation. It is arguable that this is particularly so in the case of legislation affecting international transactions where wider policy aspects are of particular significance. There is, therefore, support for some form of role for an international body or institution in advising on the approach to be taken to matters such as the existence of CFCs. The chief advantage in the use of such a body should be its ability to take a wider view of a particular issue or problem. To this end, representation on such a body should not be confined to members of the various tax authorities but would include economists, tax practitioners and tax payers.

The obvious complexity of the CFC legislation is also relevant to this chapter generally and is of specific relevance to this discussion on the economic aspects of unilateral CFC legislation. It has already been observed in earlier chapters that Subpart F and the U.K. provisions are amongst the most complex provisions in the U.S. and U.K. tax laws respectively. Indeed as early as 1970, before many

statutory complications had been added to Subpart F, a Presidential Task Force[40] stated in connection with Subpart F that:

> "The multiplicity of complex tax concepts and techniques makes it difficult for taxpayers to comply with the law and for Internal Revenue Service to enforce compliance.... Even the largest corporations with their staff of experts finds it exceedingly burdensome to comply with the requirements of the statute and the regulations. The smaller company, without experience in operating abroad and with no staff of experts, runs a serious risk of being subjected to unanticipated and harsh penalties which could have been avoided by proper but costly tax planning".[41]

The above quotation suggests that the complexity of CFC legislation can cause significant practical problems of compliance to smaller corporate taxpayers involved in international transactions. This would be particularly the case as regards Subpart F due to the mandatory requirement to report all overseas income subject to the provisions. It is perhaps for this reason that Subpart F has been referred to in the U.S. Courts as "a veil of confusion".[42] Complicated tax legislation will of course also cause difficulties for tax authorities in managing the tax system as a whole,[43] particularly where the complexity is compounded by more and more detailed amendments to the relevant legislation over time.[44]

If this complexity is an unavoidable consequence of necessary legislation it would be difficult to say anything further on the matter. However, the complexity of the legislation may itself indicate something about the likely economic benefit of having the legislation on the statute book at all. In a context not related to the CFC provisions, and arguing against the existence of the "vested interest thesis" (the thesis that tax systems are so complicated because of constant political pressure from vested interests), the economist Professor John Kay of the London Business School has argued that there are some parts of a tax system that work well and others that work badly.[45] Kay has concluded that it is the complex parts

which, in the main, are devoted to "ineffectual reinforcement of the bits that work badly".[46] The argument against complexity is developed thus:

> "Most revenue is in fact collected from relatively brief and comprehensive statutory provisions that require relatively little annual refinement and amendment. The appropriate direction of reform is to develop on and from the bits that work and to reduce the scope of the bits that do not work and reduce the dependence of revenue upon them".[47]

This line of argument is of relevance to legislation of the type adopted to tax CFCs in low tax states, since it suggests that the enactment of complicated legislation may be a mistaken policy.[48] Naturally, further work would be required in analysing, from an economic standpoint, the need for (and effect of) the CFC provisions. However, the argument against complex legislation is itself prima facie a further ground for adopting a much more rigorous economic appraisal of tax law in general and substantive provisions of IFL in particular.

SUMMARY

Perhaps the most surprising feature relating to the CFC provisions considered in this thesis is the dearth of analysis that preceded their enactment. Due to the relatively recent events in the U.K., it has been possible in earlier chapters to demonstrate this point with some force in connection with the U.K. provisions. With regard to the U.S., the evident difficulties relating to Subpart F have also been considered in part B.[49]

It may therefore reasonably be concluded that the CFC provisions of both the U.S. and the U.K. have not been enacted within the confines of any single conceptual overview of the issues raised by the activities against which those measures are directed. Without any underpinning by such a conceptual overview, the CFC provisions, as exemplified by the U.S. and U.K. provisions inevitably

raise a number of problems which have immediate consequences for the general development of IFL and particularly for the policies and principles of IFL and the primary objective underlying IFL. These problems have been explored in the course of this thesis.

The discussion of the U.S. and U.K. CFC provisions suggests that the approach of those states has largely failed to tackle the fundamental conceptual issues involved. With regard to international tax avoidance, those states enacting CFC legislation have provided no reasoned analysis of the criteria by which activities or arrangements are to be classified as amounting to "avoidance" which requires counteracting measures. Similarly, low-tax states have been targeted on the basis of an unsophisticated, one-dimensional grasp of what the tax haven concept amounts to. It is therefore virtually inevitable that the CFC provisions either fail to deal with (or amount to an implicit rejection of) certain fundamental policies and principles of IFL (e.g. the questions raised on nexus; the relationship with double tax treaties; the effect on tax havens; the unilateralist approach; etc). For this reason, and judged from the general perspective of IFL, the development of unilateral anti-tax haven legislation is to be deplored.

The CFC provisions have been considered in this thesis as a model to facilitate an examination into how developed states are attempting to deal with perceived international fiscal abuse and to evaluate how those attempts affect the development of IFL. The CFC provisions were selected originally because they were considered to involve the relevant issues in a particularly acute form. There is however no reason to surmise that the approach adopted by developed states in enacting and applying CFC rules is any different to that approach adopted with regard to other legislation designed to counter other forms of perceived international tax avoidance. It is therefore submitted that the discussion and conclusions contained in this thesis have a general (and not merely specific) relevance to the subject of IFL.

As explained in Chapter One, IFL in its widest sense is not an esoteric creation of relevance only to arcane treatises. It is rather a shorthand embodiment of policies and principles designed to achieve those fiscal goals for which there is in general a wide agreement and in respect of which there are sound grounds for support. The need to eradicate international double taxation and the need to promote equitable and (to the extent possible) neutral international tax law is a fundamental part of the development of IFL.

Until a number of the key issues raised in this thesis are fully addressed by those involved in creating substantive IFL, it is doubtful whether significant progress can be made to achieving the primary objective underlying IFL.

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CHAPTER 9 - NOTES

1 As explained in Chapter Three, the approach to CFC legislation in the U.K. and the U.S.A. is each illustrative of a more general approach which has been adopted in framing CFC legislation. The approach adopted in the U.S. case, that of targeting only certain "tainted" or passive income is, for example, characteristic of the approach reflected also in the CFC rules of Canada and Germany. The U.K. approach on the other hand, which involves attributing all the income of the CFC to its shareholders unless certain exemptions apply, is characteristic of a similar approach adopted in, for example, the rules of Japan and France.

2 O.E.C.D. Committee on Fiscal Affairs; "Taxation of Entertainers, Artistes and Sportsmen", published in "Issues in International Taxation No. 2", O.E.C.D., (Paris, 1987).

3 O.E.C.D. 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, (Paris, 1987).

4 Although there were available certain international committees (eg. the forerunners of the O.E.C.D.'s Committee on Fiscal Affairs) the influence and standing of those committees was less developed than currently. It would therefore have been quite exceptional for the U.S. to refer discussion or consideration of Subpart F to any other than a domestic forum at that time.

5 The comments in the text are not intended to suggest that there was never any discussions at all with other governments or fiscs by those states seeking to enact CFC legislation but rather that, fundamentally, the main provisions of the CFC legislation, the process of its gestation and enactment and ultimately its application have all been effected on a unilateral basis. The detailed research carried out on the position in the U.K. supports this conclusion. The author has also discussed informally many of the conclusions in the Chapter (including the comments on the unilateralist approach) with a member of the Inland Revenue's Technical Division unit which was given responsibility for applying the U.K. CFC rules from their inception.

6 See for example, note 9 Ibid, foreword by John Wakenham M.P.

7 The view that domestic issues only are involved fails to take account of issues such as the justification for the apparent extension of the tax base; the criteria by which certain international structures or activities are considered to be abusive; the concept of a tax haven, the effect of CFC legislation on the "sovereignty" of the tax haven states affected, etc.

8 It is just this sort of self-interested approach which has led to severe international criticism of the U.S. See Tax Notes, (weekly service, Tax Analysts Arlington, Va) November 7, 1988, pp.594-596.

9 For example, one of the purported justifications given by the Inland Revenue in introducing the U.K. CFC provisions was that "Introducing a new tax charge on certain U.K. controlled foreign companies resident in a low tax country would bring the U.K. into line with a number of its industrial competitors". Board of Inland Revenue, Taxation of International Business; December 1982, p.8.

10 For example, one of the justifications used by the Inland Revenue in defending the 10% de minimis limit in the case of U.K. shareholders on whom an assessment under the legislation can be raised was that "the percentage used corresponds with that of most countries which have provisions of this sort". As has been suggested in earlier chapters, the 10% threshold is in itself suspect for reasons specified earlier (both as regards the U.S. and the U.K.). The reference in the U.K. paper to foreign provisions is therefore somewhat spurious and deflects attention from the real requirement, namely an analysis of the arguments for and against a threshold set at that level. Board of Inland Revenue, "International Tax Avoidance; December 1981", p.11. This is by no means an isolated example of this process of self-legitimacy by reference to similar foreign legislation. For further U.K. examples, see Board of Inland Revenue, "Tax Havens and The Corporate Sector", June 1982, paragraph 6 and Board of Inland Revenue, "Taxation of International Business", December 1982, pp 8,30 and 46.

11 This point was emphasised by one commentator writing in 1975 in relation to the development of CFC legislation. "In 1972, Canada adopted anti-tax haven legislation similar in concept and complexity to that of the United States. Although not yet in effect, Canada has had to introduce numerous amendments to cure defects in its initial legislation, discovered merely by review of that legislation, even before the legislation was tested by practical applications. Germany has followed the same tortuous path. This illustrates the concern expressed about comparative tax law: that a country will import bad tax legislation of another country because it does not fully learn how the tax operates in practice and fails to heed the warnings of unbiased and experienced observers in the exporting country". Quoted in Sydney I. Roberts; "Fundamental and Long-term Prospects for the U.S. Tax system", remarks before the National Convention of the Taxation Institute of Australia at Hobart, April 14-20, 1975, reprinted in I.B.F.D. Bull. volume xxix, December 1975 No. 12 p.486 at p.487.

12 Note 3, Ibid.

13 The report contains very little material or "analysis" which is not already available and cannot be said to bring any new insight or technical analysis

to bear. Compared with the report on "Thin Capitalization" (see note 3 above), where wider problems appear at least to be recognised and the technical discussion introduces a number of interesting issues, the overall quality of this report is below standard.

14 Although the report itself contains no discussion of the more fundamental issues of IFL raised by anti-tax haven measures, it should be acknowledged that there is a General Introduction serving all four reports in the published volume which does discuss tax evasion, tax avoidance and tax planning. This discussion seems to repeat some questionable assumptions (for example, it appears to equate tax avoidance and tax evasion) and relies on obviously inadequate distinctions (for example, tax planning is said to relate to "consciously designed" features of a country's tax system and tax avoidance is relegated to residual activity "of the kind discussed in the reports that follow". Again, the discussion simply does not tackle the issues which are considered in this thesis to be fundamental to IFL. See "General Introduction" (Note 3, Ibid, at p. 10, especially at pp 12-13).

15 Before leaving the subject of the unilateralist approach, some further comments should be made on existing multilateral institutions. Although the tenor of the foregoing discussion is clearly to favour the use of a multilateral institution, this should not be misinterpreted as an unequivocal endorsement of existing institutions. The leading such institution is the O.E.C.D.'s Committee on Fiscal Affairs and, although that Committee has already made a valuable contribution to the development of IFL, (most notably with its model double taxation treaty of 1977, it may not be suitably equipped to deal with all issues relevant to the development of IFL. The chief disadvantage to the Committee on Fiscal Affairs is that it is staffed exclusively by representatives drawn from the fiscal authorities of the states which comprise the O.E.C.D. As such, commercial understanding of certain transactions considered by the Committee may be somewhat lacking and the perspective is inevitably somewhat one-sided. This is a serious disadvantage in the field of fiscal law and it is likely that taxpayer confidence (and support) might be increased with a more widely-drawn multilateral policy unit, including respected economists and taxation practitioners with wide commercial experience. No doubt a detailed discussion on the character and type of institutions which would most favour and promote the development of I.F.L. would be of assistance. However, discussion of this matter is not germane to this thesis beyond noting that the recommendation here for multilateral attention to major issues of I.F.L. does not represent a wholly uncritical endorsement of existing unilateral institutions.

16 There are, for example, the following comments in the U.S. white paper on s. 482: "The arms' length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it is incorporated into most tax treaties to which the United States is not a party; it has been explicitly adopted by international organizations that

have addressed themselves to transfer pricing issues; and virtually every major industrial nation takes the arm's length standard as its frame of reference in transfer pricing cases. This overwhelming evidence indicates that there in fact is an international norm for making transfer pricing adjustments and that the norm is the arm's length standard. It is equally clear as a policy matter that, in the interest of avoiding extreme positions by other jurisdictions and minimizing the incidence of disputes over primary taxing jurisdiction in international transactions, the United States should continue to adhere to the arm's length standard." See U.S. Department of Treasury; "s.482 White Paper on Intercompany Pricing", October 18, 1988, p.58.

17 This point is discussed in detail later in the chapter.

18 The development of taxation by reference to the concept of "unitary taxation" in certain parts of the U.S. is an example in point. Under this approach the global profits of a multinational group are calculated and allocated between the various associated enterprises comprising the group according to a formula which is generally based on the three factors of sales, property and payroll. The unitary tax approach is a method of allocating income within a multinational group and is therefore an alternative to the more usual (and more widely accepted) approach of treating associated enterprises as if they were independent entities. The unitary tax approach is concerned primarily with providing a basis for the allocation of revenues rather than with establishing a nexus for taxation, although there is clearly some relationship between the two. Therefore, the example of unitary taxation is not exactly analogous to the situation or concerns discussed above. However, the debate surrounding unitary taxation is illustrative of the inevitable international squabbles that will arise when it is perceived that the basis of taxation adopted by one state affecting international transactions or groups of companies is unjustified. This is precisely what happened in the case of unitary taxation, which was perceived by many states outside the U.S. to lead to a number of difficulties, and chiefly to international double taxation. Strong protests against the method were voiced by Japan and the E.E.C. and the hostilities provoked by the issues are illustrated by the description of unitary taxation by the President of the U.K. International Fiscal Association as a "tax animal which has come up from the sewers and which feeds on state greed". See H. Kogels; "Unitary Taxation - An International Approach" (1983) B.I.F.D. Bull p.65 at p.68.

19 The point can be illustrated by reference to the U.K.-Swiss treaty. it is provided in Article 7 that "the profits of an enterprise of [Switzerland] shall be taxable only in Switzerland" (emphasis added). Articles 11 and 21 make similar provisions in the case of interest and items of other income. These rules are subject to the usual exclusion concerning profits of permanent establishments but it is assumed that is not relevant to present purposes. Reverting to Article 7, two questions need to be answered: are the profits

of the (assumed) Swiss CFC profits of an "enterprise of Switzerland"? and would the effect of the CFC legislation be to tax in the U.K. the profits of the CFC, a Swiss enterprise? the answer to the first question is determined by reference to the provisions in Articles 3 and 4 of the treaty. The CFC is liable to tax in Switzerland because it is a Swiss corporation which is managed in Switzerland. It is therefore under Article 4, clearly a resident of Switzerland and it follows from the definition in Article 3 that its profits are profits of an enterprise of Switzerland. The answer to the first question is therefore "yes". On the second question, it appears irrelevant that the CFC legislation purports to tax the U.K. parent company and not the non-resident Swiss subsidiary. The U.K.-Swiss treaty does not say that the Swiss company cannot be taxed by the U.K. but rather that its profits cannot be so taxed. Under the treaty, therefore the U.K. parent cannot be taxed on or by reference to the profits of the Swiss subsidiary because that would be taxing those profits - contrary to the terms of the treaty - in just the same way as if the U.K. attempted to tax the Swiss subsidiary itself on those profits. The answer to the second question therefore also appears to be "yes".

20 See, further, H. Becker and F. Wurm; "Double Taxation Conventions and the Conflict between International Agreements and Subsequent Domestic Laws", Intertax, 1988/8-9 p.257 at pp.260-261.

21 For example, the O.E.C.D. Model Convention on Income and on Capital has led to a substantial degree of multilateral agreement which continues to exist. It is possible that part of this international agreement is to be attributed to the multilateral obligations accepted by the signatories, obligations which are of course absent in the case of existing unilateral CFC law.

22 It is considered that states, including low tax states, have a role to play in developing IFL, particularly as regards the policies, principles and pre-substantive patterns of IFL. For example, considerable work is required on the principles that are required to govern such matters as financial instruments and financial trading activities to name but one area in which the sphere of influence of the policies, principles and pre-substantive patterns of IFL could be profitably extended.

23 R.A. Gordon; Tax Havens and Their use by United States Taxpayers - An Overview, January 12 1981, pp. 213-214.

24 The type of animosity that can be aroused is perhaps well illustrated by the example of the impact of unitary taxation on fiscal relations between the U.S. and the U.K. The U.K. has now passed retaliatory legislation which can be applied to U.K. subsidiaries of U.S. companies situated in those U.S. states using the unitary tax methods. Under the new legislation, the entitlement to advance corporation tax credits on dividends paid by U.K. subsidiaries to such U.S. parents can be withdrawn (ICTA 1988, s.812).

The measure is a blatant retaliation in tax terms to what is perceived in the U.K. as an unfair and unacceptable means of taxation in the U.S. Of course, the example does not concern low tax states or CFC provisions and is a retaliation to a basis of tax adopted by local U.S. states rather than the U.S. federal fisc. However, it does serve to illustrate that hostilities can be provoked by unilateral measures which seem to lack any fiscal legitimacy. Indeed, the example is perhaps more striking because it involves two states which otherwise seem to enjoy warm relations with each other, in both fiscal and general terms. The probable existence of the sort of hostility discussed above makes the enfranchising of low tax states in the development of IFL and their participation and co-operation in such issues as exchange of information less likely.

25 With regard to the U.S. see IRC s. 901(b)(i). In the U.K. see ICTA 1988, ss. 788(1) and 790.

26 It may be objected that the criticism made in the text is relevant to double tax relief generally but is not a valid criticism of the CFC legislation. However, it is considered that in the context of the discussion in this final chapter, the criticism of the CFC rules is indeed valid. Primarily, it is the effect of the CFC rules which is the cause of the double taxation referred to, not the effect of the double tax provisions. (But for the charge under the CFC provisions, no double taxation of the sort referred to would arise). As such, it is considered a legitimate criticism of the CFC rules that international double taxation of the sort discussed in the text can be caused. It is not considered a sufficient response to this criticism to suggest that the fault is one of the framing of double tax relief provisions alone (although clearly the point does additionally raise questions as to the acceptability of double tax relief provisions more generally).

27 The difficulty in bringing this situation within the conventional category of economic international double taxation (to which it more closely corresponds) arises as a result of the assumption of the conventional classification that taxation is levied by reference to income (or capital) rather than by reference to other criteria.

28 See especially the discussion in Chapter One at pp. 17-28.

29 The U.K. rate of corporation tax was reduced to 33% for the financial year 1992 by F(No. 2) Act 1992, s. 21.

30 Under U.S. domestic provisions, a tax credit is available but only to the extent allowed for under the rules in IRC s. 960 as determined under s. 902. With regard to the relevant treaty (i.e. the U.S.-U.K. double tax treaty) it appears unlikely that a credit would be available to the U.S. company for the tax paid by the U.K. under the CFC provisions. Although credit is generally given under Article 23 of that treaty, the credit is effectively restricted - in this type of situation - to cases where a dividend is paid up

and even then is restricted to the tax on the profits out of which the payment is made - i.e. "with respect to the profits out of which such dividends are paid" (see Art. 23(1)).

31 The transfer of the shares may well crystallise a chargeable gain for U.K. tax purposes and there may also be stamp duties and VAT difficulties.

32 It is inconceivable that those enacting and administering the legislation are unaware of the result of two sets of CFC legislation applying to a single arrangement in the manner demonstrated in the text. The failure to modify the legislation in any way to take account of this possible situation provides further support for the self-interested nature of the CFC legislation in general.

33 O.E.C.D. Committee on Fiscal Affairs, "Thin Capitalization" published in, Organisation for Economic Co-operation and Development, "Issues in International Taxation No. 2" (Paris, 1987), p.8.

34 Note 33, Ibid, p.12.

35 Note 3, Ibid, General Introduction, para.22, p.14.

36 Note 35, Ibid, at paras 22 and 10. As usual, the existence and use of both companies is uncritically assumed to involve international tax avoidance.

37 In am indebted on this point to some illuminating discussions with the French economist Henri Le Page.

38 The same assumptions appear again (equally without question or analysis) in the official documents of the latest country moving toward the enactment of CFC measures, New Zealand: "The use of tax havens in particular has become widespread and has been a drain on government revenue... It is overwhelmingly clear that the New Zealand tax base must be protected from international tax avoidance". Consultative Document on International Tax Reform, New Zealand Ministry of Finance, December 1987, preface by Roger Douglas, Minister of Finance.

39 In commenting on the proposed U.K. CFC legislation, the Institute of Directors made the following comments: "The maximisation of tax revenue is preferable as an aim of policy to the minimisation of avoidance, especially if the interests of the taxpaying community are taken into account and not merely those of the tax authorities. The consultative document shows no sign of recognising the distinction either (a) between the maximisation of tax revenue and the minimisation of avoidance or (b) between the interests of the tax authorities and those of the economy as a whole." (Submission by the Institute of Directors on the Inland Revenue Consultative Document of January 1981, p.4, 28 June 1981).

40 The Task Force was established by the President of the U.S. to review the provisions of Subpart F. The Task Force was an eminent group experienced in tax matters, including two former secretaries of the Treasury and leading economists, lawyers, accountants and corporate officials.

41 Quoted in Sidney I, Roberts "Fundamental and Long-term prospects for the U.S. Tax System", Remarks before the National Convention of the Taxation Institute of Australia at Hobart, April 14-20, 1975, reprinted in I.B.F.D. Bull., volume XXIX, December 1975 no. 12 p. 486 at p. 487.

42 Tannewald J. in Greenfield v Comr. 60 TC 425 at 429.

43 For example, in 1972 a report of the Committee of the New York State Bar Association entitled "Complexity and the Income Tax" observed that "the present course of the development of the tax law, if not reversed, may well result in a break-down of the self-assessment system. Indeed, some members of the Committee believe that the break-down has already occurred." See note 41, Ibid, at p. 492.

44 It is a little early to say whether the U.K. legislation will evolve to become more and more complicated as a result of statutory changes, although the history of the U.S. legislation gives no grounds for optimism. In a U.S. Treasury report of 1976 it was said that "It can be argued that no further legislation is needed on the deferral issue. The Tax Reduction Act of 1975 substantially extended Subpart F, and as a result the principal areas of tax abuse have been closed off. Further legislative restrictions could prove counterproductive by accelerating actual distributions, triggering legislative reactions abroad, reducing the profitability and growth of American firms, adding complexity to the Internal Revenue Code and placing administrative demands on the Internal Revenue Service" (see U.S. Department of Treasury; Taxation of the Undistributed Income of Controlled Foreign Corporation, (1976), reprinted in I.B.F.D. Bull. p. 427 at p. 435. In view of the number of detailed changes to Subpart F since 1976, particularly those in the Tax Reform Act 1986, the above statement provides an ironic indicator of the likely future direction of both the U.S. and U.K. CFC provisions.

45 J. A. Kay, "Is Complexity in Taxation Inevitable?" Institute for Fiscal Studies Working Paper 57, IFS, (London, February 1985).

46 Note 45, Ibid, p. 6.

47 Note 46, Ibid.

48 The position of John Kay in this matter is, in effect at least, not far removed from the position adopted by Dr Barry Bracewell-Milnes which was considered earlier in Chapter Two. Bracewell-Milnes would

(probably) argue that the CFC legislation was misconceived on the erroneous assumption that legislation directed at preventing avoidance will therefore contribute to the raising of revenue. For Bracewell-Milnes, there is a clear distinction to be made between efforts (and legislation) directed to prevent avoidance or evasion on the one hand and efforts or legislation directed to raising revenue on the other. See further the discussion in Chapter Two.

49 Professor Stanley S. Surrey, who was assistant secretary of the U.S. Treasury at the time Subpart F was promulgated, confirmed during a conference held in 1984 that the U.S. CFC legislation was not discussed very thoroughly at the time of its adoption and that certain parts of it were not analysed in any detail at all at that time. (See conference report by Brian Arnold, "The Taxation of Controlled Foreign Corporations", Taxes International, issue 66, April 1985, p. 6).

APPENDICES

APPENDIX I

SUBPART F-SUMMARY

SUBPART F - SUMMARY

IRC Section	Summary
Subpart F	
951	Requirement that amounts of tainted earnings and profits of a CFC be included in gross income of a U.S. shareholder.
952	Subpart F income defined
953	Provisions relating to income from insurance of risks outside the country of incorporation of the CFC
954	Categories of Subpart F income defined
955	Provisions dealing with the withdrawal of previously excluded Subpart F income from qualified investment
956	Provisions that direct or indirect investment of earnings in U.S. property be treated as constuctive dividend to U.S. shareholders
957	Definitions section: CFCs, U.S. persons
958	Rules for determining stock ownership - direct,indirect and constructive ownership
959	Provision to prevent double taxation
960	Special rules for foreign tax credits
961	Provisions relating to the adjustment of basis of stock of a CFC following operation of other Subpart F rules
962	Permits individuals to elect to be taxed at corporate rates on Subpart F income
963	Repealed
964	Miscellaneous - determination of earnings and profits of a foreign corporation; treatment of blocked earnings and profits; records and accounts to be kept and made available to U.S. shareholders

Related Provisions

1248	Gains on sale or liquidation of stock in CFC taxed as income to extent of corporations undistributed and untaxed earnings and profits
1491	Imposition of excise tax on transfer of appreciated property by U.S. persons to CFCs.

APPENDIX II

U.K. CFC PROVISIONS - CONSULTATIVE HISTORY

CONSULTATIVE HISTORY

	CFC LEGISLATION	UPSTREAM LOANS	RESIDENCE
January 1981	"Tax Havens and the Corporate Sector" (consultative paper)		"Company Residence" (consultative paper)
December 1981	Section on "Tax Havens and the Corporate Sector" in Inland Revenue document "International Tax Avoidance" (paper and draft clauses)	Section on "Upstream Loans" in Inland Revenue documents "International Tax Avoidance" (paper and draft clauses)	Section on "Company Residence in Inland Revenue document "International Tax Avoidance" (paper and draft clauses)
June 1982	"Tax Havens and the Corporate Sector" (paper)	"Upstream Loans" (paper)	"Company Residence" (paper)
December 1982	"Taxation of International Business" (paper and draft clauses)	Brief section on "Upstream Loans" in Inland Revenue documents "Taxation of International Business"	Brief section on "Company Residence" in Inland Revenue documents "Taxation of International Business"
March 1983	Finance Bill (draft clauses)		
June 1983		ELECTION	

October 1983	Draft Clauses and schedules relating to Controlled Foreign Companies
March 1984	Finance Bill (draft clauses)
July 1984	Finance Act (clauses promulgated, Royal Assent 26 July 1984)

APPENDIX III

U.K. CFC PROVISIONS - SUMMARY

S.747 Definition of CFC; power of Board to make a direction; imputation (and amount) of chargeable profits and creditable tax of a CFC.

S.748 Limitations on direction-making power: exemption and exclusions.

S.749 Statutory definition of residence and interested persons.

S.750 Meaning of lower level of taxation and meaning and determination of corresponding U.K. tax.

S.751 Provisions identifying commencement, duration and termination of an accounting period. Meaning of creditable tax.

S.752 Apportionment and method of apportionment among interestedpersons; treatment of direct and indirect interests.

S.753 Notice of making of direction to be given to company and information to be given with notice: Appeals procedure.

S.754 Assessment, recovery and postponement of tax.

S.755 Revenue power to request 'relevant' information relating to potential CFCs.

S.756 Interpretation, construction and commencement.

Schedule 24 Assumptions for calculating chargeable profits, creditable tax and corresponding U.K. tax of foreign companies.

Schedule 25 Cases excluded from direction-making powers: acceptable distribution policy; exempt activities; the public quotation condition; diversion of profits (motive test).

Schedule 26 Reliefs against liability for tax in respect of chargeable profits: trading losses and group relief, etc; advance corporation tax; gains on disposal of shares in a CFC; dividends from a CFC.

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Note

This bibliography is organised into sections which correspond to the various chapters of this thesis. Where material is of general significance, or is of relevance to two or more sections, it has been included in the first section of the bibliography, ('General').

Material referred to in the two concluding chapters which is not otherwise referred to in the main body of this thesis is also cited in the first section of the bibliography.

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