ADBI
EXECUTIVE SUMMARY SERIES
No. S33/01

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# Millennium Tax Conference

20–29 September 2000, Tokyo

Executive Summary of Seminar and Workshop Proceedings

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## Key Messages

[¶] References are to paragraphs.

- **Globalization** of trade and investment combined with the increased **mobility of capital** has been driving countries to develop **efficient and effective tax systems**. It has also greatly enhanced the **risk of eroding tax bases** by creating new opportunities for tax minimization and avoidance. **[¶ 2-4, 14, 20, 44, 67, 147]**

- Globalization is not just a matter of large multinational companies establishing operations in several jurisdictions; it is also a phenomenon impacting everyone, including individuals. The current challenge to tax policy is to design **a system that does not distort private resource**

**allocation while providing adequate revenue** to finance public expenditures in a non-inflationary manner. [¶ 3, 27, 75]

- **Social objectives** may be better served **through public expenditure programs** rather than being pursued as a secondary effect of the revenue raising system. Policy issues facing Asian governments include increasing public support for **downsizing government** and promoting decentralization; **a shrinking tax base** in the wake of the Asian financial crisis; and the need to take serious note of the **impact of taxation on the poor**, given the large share of Asian economies in world poverty. [¶ 4, 6, 67, 72]

- Recent tax policy reforms in OECD countries mainly focus on **minimizing tax distortions** by broadening the tax base and lowering the tax rate. Consumption taxes emphasize efficiency, particularly the **value-added tax (VAT)**, and have gained importance in both developed and developing countries. [¶ 69, 74, 89-92]

- **Wealth taxes and taxes on immobile factors**, including immobile resources, will gain importance in the future while the **consumption tax base is likely to erode** as e-commerce becomes more important. **Environmental taxes** are attractive as they may improve income redistribution. Taxes as stabilization tools will be limited, as there is more convergence in tax policies across nations, resulting in **decreased tax autonomy**. [¶ 71, 72, 81-88]

- **Factors that have led to rapid changes in taxation** include deregulation and increased international financial flows, new communication technology, an explosion in cross-border investment opportunities, an increased importance of mobile production factors such as know-how and other intangibles, and an increased mobility of some types of labor and personnel. [¶ 7, 12, 45, 70]

- Issues of importance in **corporate income taxation** are tax competition and transfer pricing. Better advance pricing agreement procedures, secondary adjustment procedures and the development of transfer pricing arbitration systems are possible strategies to counter transfer pricing. [¶ 7-9, 16, 47-48, 69, 133]

- The Austrian system of a "**final anonymous withholding tax**" might provide an answer to the problem of tax avoidance and evasion via electronic savings. However, countries would find it increasingly difficult to tax the income of highly mobile personnel (experts) as competitive jurisdictions increasingly will degrade their tax laws for capturing this class of taxpayer. [¶ 11]

- **Harmful tax competition**, such as preferential tax regimes for financial and related services, are predatory in nature and enable foreign investors to evade or avoid tax liabilities in their home jurisdictions. The concern, for example, of the Japanese government to prevent avoidance of double taxation shifted to securing taxing rights when it became clear that other countries' domestic transfer pricing legislation would move taxing rights away from Japan. Challenges that arise out of the intersection of new environmental factors and the traditional operation of the international taxation system can be mitigated to an extent by unilateral responses such as compulsory reporting systems for foreign bank accounts. In the longer term, however, **effective solutions can only come through international cooperation**. [¶ 28, 30, 44-50]

- **Transactions between different jurisdictions** have opened the door to a broad spectrum of arbitrage arrangements by taxpayers seeking to exploit differences in tax laws. "**Double dipping**" exploits the different cross-border characterization of transactions, and differences in entity characterization and tax accounting rules. Benefits of cross-border arbitrage can be amplified by exploitation of the different treaty rules. [¶ 20]

- The policy environment has been made increasingly liberal and distortion-free in potential **foreign direct investment (FDI) locations**. More and more countries are attempting to attract FDI by offering special tax incentives although such policies are widely thought to be inefficient and are criticised on the grounds that they create distortions in the allocation of resources. Unless international coordination increases, the competitive "**race to the bottom**" between countries to offer greater concessions to attract FDI will continue. [¶ 26-30, 44]

- **Four major trends in bilateral tax treaties** have emerged. They are: (i) reliance on the 1963 OECD model tax treaty and its successors; (ii) the decreased use of tax sparing provisions; (iii) the growing recognition of treaty abuses and their counteractive measures; and (iv) the continuing explosion in the number of treaties despite their questionable utility. Two major types of treaty abuse are: *double non-taxation*, when one treaty partner exempts certain income on the misunderstanding that it will be fully taxed in other contracting jurisdictions; and *treaty shopping*, which arises due to differences in the wording of tax treaties. [¶ 32-43]

- Enterprises can **rearrange transactions to be outside the taxing rights** of a source jurisdiction in the case of both the OECD and the UN model tax treaties. The advent of **electronic commerce**, in particular, allows enterprises considerable latitude to weaken those ties with the source jurisdiction that are relevant for the treaty concepts of a permanent establishment to apply. [¶ 41-43]

- The national tax systems are confronting increasingly sophisticated methods of **tax evasion and tax avoidance**. The number of **tax havens** has tripled during the past thirty years and there has been a noticeable proliferation of preferential tax regimes, such as offshore banking, and headquarter companies. Against this background, OECD started its project to combat harmful tax practices in 1996. Work on this project is continuing through reviews of legislation in member countries and dialogue with non-member countries. [¶ 41-50]

- **Institutional strengthening** to increase **the effectiveness and efficiency** of revenue administration is vital. Effective institutions provide clear and transparent rules to guide policy and actions, promote contestability and competition, and institutionalise effective feedback or "citizens voice" to ensure accountable and responsive administration. Mission and vision statements of tax administration organizations play a crucial role. [¶ 56-60]

- Experience strongly suggests that **administrative reforms** will be unsuccessful without the will to reform at the political level and strong management capabilities at the working level. Furthermore, **operational autonomy and flexibility** of the tax administration, such as through the institution of revenue boards, are needed to fulfil its mission effectively and efficiently. Evidence exists of **efficiency gains** from setting up units. Measurable performance indicators are needed to gauge the extent of mission fulfilment and the degree to which targets are met. [¶ 51-54]

- **Anti-corruption strategy** for tax administrations should address motive by focusing on organizational image and status, positive and negative incentives for officials, and supply-side penalties coupled with the protection of taxpayer rights. Opportunities for corrupt behavior should also be reduced through tax simplification, organizational restructuring and functionalization, independent external audit and the concern and voice of citizens. [¶ 56-57]

- Socialist tax systems were characterized by a small number of taxpayers, heavy reliance upon profit taxation of enterprises and multi-rate turnover taxes, and a relatively underdeveloped tax administration. **Transition to a market economy** necessitates replacing the existing enterprise profits tax with a corporate income tax levied on profits computed according to market principles. Some other areas for reform include introducing a comprehensive personal income tax, replacing the turnover tax with a VAT, supplemented by a few selective excise taxes, and modifying import and export taxes to conform to WTO rules. [¶ 74-79]

- In many developing countries, however, the agriculture sector is taxed through the use of marketing boards, overvaluation of domestic currencies and an industrial protection system with an agricultural bias. For consideration of **tax on agriculture**, a land tax is neutral and probably progressive in incidence though it has high administration cost. [¶ 80]

- The growing use of **green environmental taxes** results from the need for adoption of more effective and efficient environmental policies rather than command and control instruments. Also the **double dividend hypothesis** suggests that substituting green taxes for existing distortionary taxes not only produce a cleaner environment but also reduce inefficiency since most traditional taxes adversely affect work, savings and investment. For the double dividend hypothesis to hold, however, cost-reduction from the revenue-recycling effect would have to outweigh both the direct and the indirect cost. [¶ 81-82]

- The use of **information technology**, including the Internet, has made tax administrators' work difficult, particularly as it relates to business to consumer retailing. Generally, **sales tax or VAT is avoided** either because mail-order firms do not have to collect such taxes or because customs officials cannot open all small packages entering the country. More complicated is the **case of digital products** sold and downloaded from the Internet by individual buyers at the household level. [¶ 92]

- The **impetus toward greater decentralization** is provided by the desire for smaller and more responsive government, fiscal constraints of national governments to meet growing demand for local services and other country-specific developments. Assignment of revenue collection powers to jurisdictions should be predicated on assignment of expenditure responsibilities as well. Ability-to-pay taxes should largely be assigned to the central level, as the responsibility for national redistribution policy is at that level while taxes based on the benefit principle, fees and charges are appropriate functions for local governments to perform. [¶ 93-97]

- There is the need for further examination of problems raised by **e-commerce**, including the issue of Internet savings, the importance of administrative strengthening by the use of well-defined mission statements and through increasing use of information technology and the need to broaden the scope of cooperation and dialogue between countries. [¶ 11, 19, 130, 146]

- It is also important to explore the possibility of establishing an institutional framework (e.g. a regional association of tax policymakers) for **regular policy dialogue and tax policy cooperation in the Asia and Pacific region** where no institution exists at present for such a purpose. [¶ 145-146]

## Introduction

**1.** The millennium conference conducted in the ADB Institute premises in Tokyo had two events: a seminar on International Taxation from 20 to 22 September 2000 and a training workshop from 25 to 29 September 2000. The conference was jointly organized and sponsored by the ADB Institute, the

ADB, the Tax Bureau of the Ministry of Finance, Japan and the Organization for Economic Cooperation and Development (OECD). Dr. R.B. Adhikari, Senior Capacity Building Specialist, ADB Institute was the Officer-in-Charge of the conference, with support provided by Mr. Teruo Ujiie of the Asian Development Bank (ADB), Manila.

## The Seminar on International Taxation

2. During the opening ceremony, **Mr. Yo Takeuchi, Deputy Director General, Tax Bureau, Ministry of Finance** welcomed the participants on behalf of the **Government of Japan**. He suggested that an interesting dialectic will confront the participants to the conference as they wrestle with conflicting issues. On one hand, the globalization of trade and investment combined with the increased mobility of capital may drive countries to develop efficient and effective tax systems. On the other, globalization has greatly enhanced the erosion of tax bases by creating new opportunities for tax minimization and avoidance. The key to confronting the risks to tax systems could enhance multilateral cooperation.

3. **Mr. Myoung-Ho Shin, Vice-Present (West), ADB**, observed during his welcoming address that while globalization has led to substantial economic growth and a reduction in the number of poor in Asia over the past four decades, the number of persons living in absolute poverty has increased. Shin urged participants to bear this in mind as they consider the implications of **tax policies for the poor**. Next, Shin highlighted the fact that taxation can play a key role in the distribution of income and wealth but also noted that highly progressive and redistributive tax systems could discourage formal economic activity and foster evasion and avoidance. In this view, the greatest challenge, therefore, is to design a tax system that does not distort private resource allocation but provides adequate revenue to finance public expenditures in a non-inflationary manner. This consideration, as well as a recognition of administrative limitations, has led to a shift in many countries to rely on consumption taxes with the consequence that governments must consider other ways of achieving redistributive goals.

4. **Mr. S. B. Chua, Director, Capacity Building, ADB Institute**, delivered the opening remarks on behalf of **Dr. Masaru Yoshitomi, Dean, ADB Institute**. Yoshitomi in his prepared remarks had explored the relationship between tax policy as an instrument for mobilizing resources for promoting economic growth and social development and the assertion by many that highly progressive tax structures may discourage economic growth. He suggested that social objectives might be better served through public expenditure programs, than pursued as a secondary effect of the revenue raising system. The shift to indirect and proportional direct taxation is as a result of consequences following from this shift in thinking. Yoshitomi set the stage for a discussion of the objectives of the Tax Conference. He pointed out that globalization, and in particular cross-border investment, has sharpened the focus on a number of tax issues, particularly the need to avoid lacunae and overlaps in tax systems for cross-border transactions. He asked whether traditional bilateral treaties would be sufficiently robust to cope with the pressures of increased globalization or whether the time has come to opt for multilateral solutions.

## The Training Workshop

5. On behalf of the ADB Institute, Chua welcomed the delegates and the resource speakers of the workshop. In his opening remarks, **Dr. Jungsoo Lee, Resident Representative** in the **Japanese Representative Office, ADB**, explained the rationale for the conduct of the annual workshops on taxation. The reason is that ADB recognized the importance of appropriate tax policies in promoting economic growth and enhancing social welfare. He identified the high quality of participants and resource persons as the key ingredient in their continuing success.

6. He went on to identify four key current challenges faced by governments. The first was the increased public support for downsizing governments and decentralization. The second was the continuing emergence of new international taxation issues due to increased globalization. The third was the shrinking tax base in the wake of the Asian financial crisis. The need to raise additional revenues conflict with the equally urgent requirement to provide the corporate sector with a flexible environment to allow recovery from the crisis. The fourth was the need to take serious note on the impact of taxation on the poor, given the large proportion of the world's poor living in the Asia and Pacific region.

## Keynote Address: International Tax Issues in a Rapidly Changing World

7. **Professor Sven-Olof Lodin, President, International Fiscal Association**, in his keynote address, outlined factors that had led to rapid changes in key tax issues. These included deregulation and increased international financial flows, new information and communication technology, an explosion in cross-border investment opportunities, the increased importance of mobile production factors such as know-how and other intangibles, and the increased mobility of some types of labor. The tax issues arising out of these factors concern not only revenue, but also the fairness of the tax systems and their potential to affect income distribution. He focused his analysis on three areas of taxation, namely, corporate income, electronic trade and personal income. Two issues were of importance in the area of taxation of corporate income, namely tax competition and transfer pricing.

8. Lodin stressed, as did virtually every other speaker at the conference, that tax competition per se is not viewed as a problem. Rather, the concern is **harmful or unfair tax competition**. Both the OECD and the EU have recognized that tax competition can become harmful. To date, the focus of

the OECD in its harmful tax competition project has been in the area of financial capital investments and not in the so-called “real” investments in the productive sectors of the economy. By way of contrast, the EU is moving to address the question of competitive tax concessions for “real” investments. It was noted that since EU members form a majority of the OECD, the latter might soon face pressure to widen the scope of its harmful tax competition initiatives.

9. Lodin also addressed the issue of **transfer pricing**. He offered many suggestions for jurisdictions confronted by transfer pricing problems. He discussed the need for better procedures for advance pricing agreement (APA) and secondary adjustments and the development of transfer pricing arbitration systems as soon as possible. In particular, he pointed out that uniform documentation rules would contribute greatly to help all jurisdictions.

10. In his discussion of **e-commerce and tax issues**, Lodin provided a realistic appraisal of the problems to be faced in this area. It was clear from his discussions that the OECD still has a long way to go to resolve e-commerce tax issues within its membership to reach international consensus. Pending development of that consensus, the EU is moving ahead with proposed unilateral solutions but it remains to be seen whether the European approach will work in other jurisdictions or, for that matter, within the EU itself.

11. Moving to the question of **taxes on personal savings**, he provided an equally realistic appraisal of the difficulties that governments face in taxing income from personal savings and, in particular, interest. He highlighted the experience of several jurisdictions’ unsuccessful attempts to tax interest income and suggested the Austrian system of a final anonymous withholding tax as a possible solution to the problem.

12. Lodin concluded with a brief discussion of the problems jurisdictions face in taxing income derived by **highly mobile experts**, particularly where tax competition is providing more concessions. He concluded that countries would increasingly find it difficult to tax their income since competitive jurisdictions would increasingly degrade their tax laws to accommodate this class of taxpayer.

## Theme 1: International Taxation

### *A. International Tax Issues in Japan*

13. **Mr. Jun Sugie, Director, Tax Bureau, Ministry of Finance, Japan,** spoke on a broad range of international tax issues from a Japanese perspective. Drawing upon materials prepared by the Tax Commission of the Japanese government, Sugie covered three topics in his presentation — the environment surrounding international taxation, key elements of the international tax system and the challenges facing governments when resolving international tax issues.

14. In his review of the international tax environment, Sugie pointed out that globalization, the first environmental factor surrounding international taxation, is not just a matter of large multinational companies establishing operations in several jurisdictions; but rather it is a phenomenon that affects every individual. Globalization has led to the elimination of trade barriers and restrictions on transfer of personnel and the withdrawal of controls on foreign exchange transactions — in short, equivalent to the signaling of the birth of a world economy without sovereign borders. It was clear that globalization offers many potential benefits, including increased efficiency and productivity. At the same time, however, it greatly exacerbates the tax problems that can arise in respect of cross-border transactions. These problems are likely to increase as the continued deregulation of the financial sector increases cross-border investment.

15. A second environmental factor developing alongside deregulation and those aspects of globalization that would lead to a greater cross-border investment is the growth of an information age, including e-commerce that facilitates cross-border transactions and the rise of intangibles and services in the new economy.

16. The third environmental factor noted by Sugie is the growth of harmful tax competition through the adoption of preferential tax regimes for financial and related services. In one view, many of these regimes were predatory in nature, having as their principal aim the creation of an enabling environment for foreign investors to evade or avoid valid tax liabilities in their home jurisdictions.

17. Sugie next turned to an analysis of traditional international tax issues. Traditionally, the key aims of international tax initiatives have been to avoid international double taxation and to secure or allocate taxation rights. This is normally accomplished through a combination of domestic legislation and bilateral agreements. The Japanese experience, however, does not reflect such arrangements. The initial concern of the Japanese government in the latter half of the twentieth century was to avoid double taxation. The concern shifted subsequently to one of securing taxing rights when it became clear that the domestic transfer pricing legislation of other countries would have the effect of moving taxing rights away from Japan. The response of the Japanese government was then to work for multilateral solutions primarily through the OECD.

18. The challenges arising out of the intersection of new environmental factors and the traditional operation of the international taxation system are similar for all countries. Unilateral domestic responses such as compulsory reporting systems for foreign bank accounts or requirements that domestic institutions report transfers abroad can mitigate some problems. In the longer term, however, effective solutions can only come through international cooperation. It was suggested that OECD initiatives on agreements such as those for the exchange of information will be important in this respect and non-mem-

ber Asian countries were urged to establish dialogues with the OECD so they could be part of this process.

## B. Electronic Commerce and Taxation: Summary of the Issues in the Asia-Pacific Region

**19. Professor Rick Krever, School of Law, Deakin University, Melbourne, Australia,** started his presentation by stating that no subject has captured the imagination of tax commentators in the past few years more than the impact of electronic commerce on tax systems. If one were to judge from the interest in the subject alone, it would be easy to conclude that electronic commerce is the pivotal issue facing tax administrators at the dawn of the new millennium with the very future of some tax bases at stake. Krever expressed the view that for the moment, the overall impact of e-commerce on tax systems may be exaggerated. He recognized, however, that e-commerce will one day place enormous strains on some aspects of consumption tax bases and will test the boundaries of some important international income tax concepts such as the character (type) of income, the source of income and the permanent establishment criteria. Key questions in taxing e-commerce transactions are listed in **Box 1**, and for a more elaborate discussion on taxation of e-commerce, please refer to ADB Institute's Executive Summary Series No. S13/00 on 1999 Tax Conference, also available at **www.adbi.org**

**Box 1: Key Questions in Taxing E-commerce Transactions**

*Using the Internet to order tangible goods*
- Can the customs and postal services deal with the growth of individual cross-border orders?

*Using the Internet to order (or deliver) intangible (digital) products*
- How can tax-free exports be distinguished from taxable domestic sales?
- Can an electronic invoice be used as a tax invoice?
- Is it practical to impose tax on the importers of digital products?
- Can non-resident suppliers of digital products be required to register and pay tax on their supplies?
- How can tax liabilities be imposed if the supplier has no connection with the internet customer's country?

*Using the Internet to order (or deliver) services*
- How can tax be imposed on business importers of Internet-provided services?
- How can tax be imposed on non-business importers of Internet-provided services?
- Can suppliers be required to pay the tax on cross-border Internet-provided services?

## C. Cross-Border Tax Arbitrage

**20.** Globalization has exposed differences in national tax systems where transactions cross between different systems. It has also opened the door to a broad spectrum of arbitrage arrangements by taxpayers seeking to exploit those differences. **Mr. Lee Burns of the Faculty of Law at Sydney University and Krever** discussed the design of arbitrage arrangements and responses that national tax authorities can take to combat those arrangements, which threaten the revenue base. They explored three ways for arbitrage arrangements – double dipping through different cross-border characterization of transactions, exploiting differences in entity characterization and exploiting differences in tax accounting rules.

**21.** The phenomenon of different cross-border characterization was illustrated, using a lease arrangement. Depending on how it is structured, some jurisdictions would treat a lease as an operating lease, meaning payments under the lease would be considered as ordinary rental payments. Other jurisdictions would consider the same lease to be a finance lease, meaning that it would be treated as the equivalent of a sale to the lessee on credit terms involving payment of the price of the sale including interest over the term of the lease. If taxpayers are able to structure a lease that can exploit the different characterizations, it will be possible for two different taxpayers in two different jurisdictions to take depreciation deductions in respect of the same asset. Parallel arrangements can be used to transfer tax deductions from non-taxable entities such as government-owned bodies to taxable entities.

**22.** It was seen that the benefits of cross-border arbitrage of this sort could be amplified by exploitation of different treaty rules. Well-advised taxpayers will route a transaction through the jurisdiction that has the most favorable tax treatment in a treaty with their country. Where parties to a transaction are related, cross-border arbitrage can be used to save taxes for the overall group of companies. Where parties to a transaction are not related, the tax savings from arbitrage arrangements are usually shared between them. If both parties can use tax benefits directly, they are shared directly. If only one party can use tax benefits (as would be the case where the other party is tax-exempt or in a loss position so it does not need tax benefits), the tax savings are usually allocated to the party who can enjoy them directly while the other party is rewarded with a lower cost for interest or rental payments, depending on how the transaction between the parties has been structured.

**23.** The second form of cross-border arbitrage analyzed was the use of hybrid entities that enjoy different classifications in different jurisdictions. Two variations were explored: one concerns entities that are known in both jurisdictions but treated as different entities for tax purposes in each jurisdiction; another concerns entities that are not known in both jurisdictions. An example of the former is a limited partnership, which might be treated as a flow-through entity in one jurisdiction and a separate entity in the other. An example of the latter is a civil law foundation that might be classified as a company subject to separate entity taxation or as a trust subject to flow-through taxation in a common law jurisdiction. Examples showed how an expense incurred by a hybrid entity might be deductible to the entity in one jurisdiction and to the members in another. The session on hybrid entities also considered the impact of the US "check-the-box" rule that allows taxpayers to nominate the tax characterization they wish their entity to receive for tax planning purposes.

24. The final form of arbitrage reviewed was that of arbitrage timing, which exploits the tax accounting rules that dictate when taxpayers will be required to recognize income and when they will be allowed to recognize expenses. Arbitrage opportunities arise if taxpayers on either side of a transaction can arrange to be subject to different tax accounting rules for the same transaction. This can occur, for example, if the accruals recognition used by a borrower allows him to deduct a discount over the life of the loan while the lender is able to defer recognition of gain until the loan is redeemed. Another example explored in the seminar was an installment sale in which the vendor might be able to defer recognition of gain on the disposal of an asset or to re-characterize imputed interest in an installment sale as a capital gain, which may be subject to concessional treatment.

25. The cross-border arbitrage sessions provided participants with an overview of the types of opportunities for tax minimization that arise in cross-border transactions and the ways such opportunities may be exploited by taxpayers.

## *D. Recent Trends in Tax Incentives*

26. **Professor Alex Easson, Queens University, Canada,** reviewed key issues and recent trends in the use of tax incentives to attract FDI, placing greater emphasis on the design and operation of different incentives.

27. Studies suggest that tax considerations are becoming increasingly important in deciding where to locate FDI, and more countries are attempting to attract FDI by offering special tax incentives. Although such incentives are widely thought to be inefficient, and are criticised on the ground that they create distortions and result in the inefficient allocation of resources, many countries feel compelled to provide them in order to compete for investment. Easson then went on to review the uses of different types of incentives **(Box 2)**.

28. Harmful tax practices are designed to create tax incentives to promote certain types of activities such as regional development, employment creation, technology transfer, and production for export. The granting of preferential tax treatment to certain sectors, or activities, has been a common practice ever since taxes were first introduced. Some countries restrict incentives to certain broadly listed activities or sectors of the economy. However, recently the practice has widened to include much more selective incentives narrowly targeted at particular types of foreign investment, especially technologically advanced investment and some more mobile types of activity.

Box 2: **Commonly Employed Forms of Tax Incentives for FDI**

- Reduced rates of corporate income tax for particular activities or types of enterprise
- Tax holidays (i.e. reduction or exemption from tax for a limited duration)
- Investment credits or allowances for investment in capital assets
- Accelerated depreciation of capital assets
- Deductions or credits for reinvested profits
- Reduced rates of withholding tax on remittances to the home country
- Personal income tax and social security reductions for executives and employees
- Property tax reductions
- Reduced import taxes and customs duties
- Creation of special economic zones

29. Other issues to be considered in designing investment incentives are whether relief from taxes should be granted automatically where prescribed conditions are met, or be given only on a discretionary basis. Also at issue is whether they should be restricted to foreign investment or be also available to domestic investors as well. Restricting the availability of incentives reduces their cost but at the expense of increasing their distortionary effects.

30. Easson closed with a survey of international efforts to prevent revenue erosion through the granting of competitive tax concessions to attract FDI, paying particular attention to the role of IMF conditionality and the recent OECD initiative to curb harmful tax competition. Regarding WTO rules, he pointed to limitations on the use of incentives, which act as de facto export subsidies, citing recent WTO decisions regarding "Foreign Sales Corporations" in the United States and ongoing negotiations preceding the entry of the People's Republic of China into the WTO. Unless international efforts intensified, Easson is of the view that countries would continue offering greater concessions to attract FDI in a competitive "race to the bottom".

## *E. International Taxation and Tax Treaties*

31. Two complementary presentations on taxation were delivered on international taxation and tax treaties. While Easson discussed recent trends in tax treaty design, Burns examined key features that are common to the majority of existing and likely future tax treaties.

32. **Easson** identified four major ongoing trends in bilateral tax treaties among countries. First, almost all treaties since 1963 were based on the 1963 OECD Model Tax Treaty and its successors, including the United Nations model (most treaties prior to this were based on its forerunner, the 1928 League

of Nations model). Recent developments represented attempts to fine-tune the OECD model to take into account recent developments in international taxation and business conditions. The second trend is the falling from favor of tax sparing provisions, following a 1998 OECD report. The third trend is the growing recognition of treaty abuses and measures to counteract such abuses. The final trend is the explosion in the number of treaties in recent years, a trend that Easson found of questionable utility.

**33.** Regarding fine tuning, a major issue, identified in the 1999 OECD working group report, is the entitlement to treaty benefits, given the existence of partnerships, and "flow-through" or hybrid commercial entities. Such entities pose problems when they are neither individuals nor corporations as conventionally defined in at least one treaty jurisdiction. Typically, the entity will face a tax liability according to the laws of the country from which its income is derived even if its status in the source country differs from the status in the country from which it derives its legality. Such anomalies could give rise to either double taxation or non-taxation of the entity.

**34.** A second issue concerns problems posed by electronic commerce, particularly with regard to the definition of permanent establishment as discussed by Krever. The third major issue concerns the elimination of the distinction between "independent personal services" and "business profits" and the related distinction between "permanent establishment" and "fixed base" which figured in Article 14 of the earlier versions of the OECD Model Tax Treaty.

**35.** With regard to tax sparing, OECD countries have become less ready to include such provisions in their treaties. Tax sparing encourages host countries to provide incentives to FDI and so should be discouraged along with granting of incentives. Furthermore, tax sparing provides incentives to firms to engage in treaty abuse, particularly treaty shopping. Furthermore, tax sparing encourages excessive profit repatriation, which leads to decreased benefits from FDI for host countries.

**36.** Easson identified two major types of treaty abuse or taxpayer use of treaty provisions in a manner not intended by contracting countries. One type concerns double non-taxation that could occur when one treaty partner exempts certain income on the incorrect understanding that it will be fully taxed in the other contracting jurisdiction. The second is treaty shopping, which arises due to differences in the wording of tax treaties. Here, a company from country X, instead of directly setting up a subsidiary in treaty-partner country A, may be able to reduce its tax liability by setting up a subsidiary in country B (which has a separate treaty with X) and setting up a subsidiary of its country B subsidiary – a sub-subsidiary – in country A. Other forms of treaty shopping occur when a resident of country X sets up a subsidiary in country Y in order to take advantage of an X-Y treaty to lower their tax burden. Such "round-tripping" could, in some cases and jurisdictions, be fraudulent. Besides adoption of unilateral or bilateral general and targeted anti-abuse rules, the major co-ordinated initiative to counter treaty abuse, particularly through tax havens is via the OECD's harmful tax competition initiative, discussed below.

**37.** In analyzing the fourth major trend relating to the growth in the number of tax treaties, Easson expressed the view that many of these treaties were irrelevant given the limited commercial interaction between contracting countries except that the scope for treaty abuse could increase. Among possible alternatives for the 21st century multilateral tax treaties, incorporation of tax issues in multilateral trade or investment pacts and harmonized reforms of domestic tax laws in accordance with a modern tax law were possible options. While none of these options were perfect, he advised countries to take the initiative in reforming their domestic laws without giving too much importance to expanding their networks of bilateral treaties.

**38.** The workshop session on tax treaties conducted by **Burns** examined issues of income characterization, source rules and the definition of permanent establishments in tax treaties. The discussion was based around hypothetical cross-border transactions involving the supply of computer software and the issues were explored through the active participation of workshop participants.

**39.** When determining taxing rights, the first issue to be resolved is the characterization of income since different source rules will apply to different types of income. In the case of software, the "sale" agreement normally specifies that only a license is being supplied to the customer, which means in a strict legal sense the payments for software can be characterized as royalty payments. However, in substance the transaction could be regarded as a sale in which conditions were imposed on the purchaser. Under many domestic laws and double tax agreements, business profits from a sale would, prima facie, be taxable only in the vendor's country while royalties would be taxable in the customer's country.

**40.** Discussion by workshop participants showed that many jurisdictions would look at the legal form of the transaction and characterize the payments as royalties while some would adopt the substance approach and characterize the gains as business profits, a position advocated by OECD. The practical consequences of different characterizations, including the practical problems of collecting tax when payments are regarded as royalties, were explored in some depth during discussion.

**41.** The workshop session next assessed the circumstances under which customer's jurisdiction could assert taxing rights if the transactions were regarded as yielding business profits and not royalties to the vendor. International treaties and many domestic laws extend taxing rights over business income to the source jurisdiction where a non-resident taxpayer maintains a "permanent establishment" in the source jurisdiction. Workshop participants considered the permanent establishment concept in the context of a series of hypothetical arrangements to which the OECD and United Nations model tax treaty provisions were applied. The hypothetical case considered was a vendor who enjoyed no contact with the source country apart from filling in the order form from abroad. Its ties with the jurisdiction were gradually increased, first by using a web page posted by a third party's server in the source jurisdiction and then by the use of its own server in that jurisdiction. It moved on to the use of an agent in the jurisdiction, a representative office, and finally a subsidiary. Slight variations of the facts, for example, include the agent or representative office holding a small stock of goods for filling occasion orders or advising the foreign supplier on aspects of the sale contracts to test critical boundaries of the permanent establishment concept. There was extensive discussion of the income taxation of cross-border e-commerce business.

**42.** Many of the factual variations examined in the workshop were used to test the boundaries between the OECD and UN model tax treaties. Issues reviewed in this context include the rule in the UN treaty that treats an agent as a permanent establishment if the agent *regularly* delivers goods or merchandise on behalf of a non-resident enterprise. Generally, it was seen that the OECD treaty tends to look at formal aspects of a sales contract as an indicator of source while the UN treaty tends to look at other aspects of a transaction such as actual delivery that may be considered essential elements of a sale. Another variation between the treaties that was looked at is the proviso in the UN treaty that seeks to preclude an agent from being an independent one if the agent acts *wholly or almost wholly* on behalf of a single non-resident enterprise.

**43.** The examples employed in the workshop showed how enterprises could rearrange transactions to lie outside the taxing rights of a source jurisdiction in the case of both the OECD and the UN treaties. The advent of electronic commerce, in particular, allows enterprises considerable latitude to weaken the ties with the source jurisdiction that are relevant for the treaty concepts of a permanent establishment. The workshop also exposed many of the practical problems jurisdictions will face in collecting taxes where taxing rights can be established in cross-border transactions.

## *F. Harmful Tax Practices*

**44.** **Messrs. Torsten Fensby** and **Makoto Nakagawa** of the Organization for Economic Cooperation and Development (**OECD)** gave a very important presentation that attracted much discussion. Fensby presented the backdrop of the OECD's work on harmful tax practices. Globalization in trade and investment, deregulation of financial markets, elimination of exchange controls and new information and communication technologies are putting new pressures on national tax systems. Tax administration remains national, posing challenges to countries to adapt to the rapid globalization of businesses. At the same time, national tax systems are confronting increasingly sophisticated methods of tax evasion and tax avoidance. The number of tax havens has tripled during the past thirty years and preferential tax regimes, such as offshore banking, and headquarter companies have proliferated. These regimes, it was argued, are often utilized for international tax evasion and avoidance. As the number of havens and preferential regime increases, a "race to the bottom" is taking place, leading to "double non-taxation" in the world. Revenue loss from tax base shifts to havens and preferential regimes in other jurisdictions has forced national jurisdictions to increase the tax burden of less mobile factors such as labor, property and consumption, which affects the fairness of their tax systems. Furthermore, complex anti-avoidance provisions such as the Controlled Foreign Companies rules become necessary, raising administrative costs and compliance burdens.

**45.** From the standpoint of world economic welfare, capital and financial flows driven by tax avoidance motives cause misallocation of resources, resulting in possibly lowering global economic growth for all OECD member and non-OECD countries. Against this background, OECD started a project to combat harmful tax practices in 1996, which has now culminated in the issuance of a series of reports and the conduct of forums for seeking views from both the OECD and non-OECD countries.

**46.** The 2000 report sets out the progress made in identifying and curtailing harmful tax practices both within and outside the OECD. It identified 47 tax regimes in OECD countries as potentially harmful preferential regimes. Furthermore, 35 jurisdictions were identified as meeting the criteria for being tax havens. This list, it was pointed out, was produced *not* as a basis for possible coordinated defensive measures, but rather as a basis for cooperation with those jurisdictions to promote changes to comply with the principles of the 1998 report. The 2000 report also provided an update on work with non-OECD countries and made proposals for strengthening this dialogue.

**47.** The OECD project deals only with geographically mobile activities such as financial and other service activities. Tax incentives to attract real investments in plant, building and equipment are not covered by the project, though the OECD intends to explore this issue in the future. Second, the project attempts to distinguish "harmful" tax competition from "fair" tax competition. According to the 1998 report, "harmful" tax competition is identified as a combination of low tax rates and other features, whose principal purpose is to "poach" other countries' tax bases. Lower general tax rates than other jurisdictions *per se* are not regarded as "harmful". This project supports "fair" tax measures for the pursuit of domestic policy goals as those that are not aimed at other countries' tax bases. More generally, the OECD supports the trend to lower tax rates and broaden tax bases. Third, it was pointed out, the OECD project supports fiscal sovereignty of each tax jurisdiction as long as jurisdictions abide by internationally accepted standards. Consequently, what the project aims at is international coordination or cooperation to combat harmful tax practices and not harmonization. Consequently, the OECD recognizes that cooperation with non-OECD countries is crucial. The OECD cooperates and engages in dialogue with non-OECD countries through its outreach activities, which it plans to strengthen in 2001.

**48.** In his presentation, Fensby then went on to define harmful tax competition and provided several examples of such competition **(Box 3)**.

**49.** Regarding effective exchange of information, the OECD presentation recognized that a country could be constrained in exchanging information because of secrecy laws, which prevent the tax authorities from obtaining information requested by other countries on taxpayers benefiting from the operation of the preferential tax regimes. In this regard, OECD issued a report in April 2000, calling for limits to bank secrecy for tax purposes. Of the 35 tax havens listed in the 2000 Report, six jurisdictions (Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino) that had made a public political commitment to eliminate their harmful tax practices by the end of 2005 were not included in the list. The OECD has invited other jurisdictions in the list to consider making commitments to eliminate harmful tax practices. Any jurisdictions in the list that does not make commitments by 31 July 2001 to eliminate such harmful practices would automatically be included in the OECD's List of Uncooperative Tax Havens. To recognize ongoing efforts by some jurisdictions and encourage jurisdictions to make commitments, coordination of defensive measures foreseen in the 1998 report would not be implemented before 31 July 2001.

**50.** The 1998 report also called for OECD countries to adopt *Guidelines for Dealing with Harmful Preferential Tax Regimes in Member Countries*. Under these guidelines, harmful features of preferential tax regimes in OECD countries must be removed within 5 years (by April 2003). The Guidelines also include a "standstill" provision requiring OECD countries to refrain from adopting new, or extending the scope of existing harmful tax practices. Each member country was also asked to perform a self-review of its preferential regimes with regard to harmful competition criteria. Simultaneous cross-country reviews were undertaken and a peer review process was completed for each reported preferential regime. Categories of preferential regimes reviewed included Insurance, Financing and Leasing, Fund Managers, Banking, Headquarter Regimes, Distribution Center Regimes, Service Center Regimes, Shipping and Miscellaneous Activities. In the next step of the work, the Forum on Harmful Tax Practices will develop guidance (i.e. application notes) on applying the preferential regime criteria in the 1998 report to the categories and types of preferential regimes in a 2000 report. The Forum will report back to the OECD Council no later than June 2003 to list any

### Box 3: How OECD Identifies Harmful Tax Competition: Four Key Factors

The OECD's 1998 report describes four key factors used in identifying tax havens and harmful preferential tax regimes in non-haven jurisdictions.

**Low, nominal or zero tax rates** is the first criterion. Although this criterion is necessary, it is not sufficient. When combined with one or more of the following three factors, the tax regime concerned is regarded as a "harmful" tax practice. Consequently this criterion is termed the "*gateway criterion*", while the remaining factors are called "*operative criteria*". The low effective tax rate must be a special rate for mobile income. If it is an overall general rate, it does not meet the "gateway criterion."

The second criterion is existence of **"ring-fencing."** A tax regime is "ring-fenced" when it is partially or fully isolated from the domestic economy. Since the regime's "ring-fencing" effectively protects the sponsoring country from the harmful effects of its own incentive regime, the regime will have an adverse effect only on foreign tax bases. In the case of tax havens where there may limited domestic economic activity, ring-fencing is substituted by the criterion of absence of substantial economic activity. Ring fencing may take several forms, such as a regime that explicitly or implicitly restricts its preferential benefit to non-residents or one where investors benefiting from the regime are explicitly or implicitly (de facto ring-fencing) denied access to the domestic market of the host jurisdiction are typical forms.

The third criterion is **lack of effective exchange of information** on taxpayers benefiting from the low tax jurisdiction. This protects taxpayers against scrutiny by home country tax authorities, facilitating tax evasion and money laundering. Lack of effective exchange of information is regarded as the most important operative criterion in identifying both tax havens and harmful preferential tax regimes. Effective exchange of information can be judged on three dimensions: relevant information needs to exist; tax authorities need to have access to it; information needs to be exchangeable. Failure in any one aspect can lead to lack of effective exchange of information.

The fourth criterion, applicable in the more general sense, is **lack of transparency** in the operation of tax regimes. Lack of transparency can be judged by examining the legislative or administrative provisions. Non-transparency arises, (such as when legislation, guidelines or rules governing certain tax regimes are not clear, not sufficiently detailed or not published) and prevents other tax jurisdictions from ascertaining how the regime actually works. Excessive administrative discretion involved in the operation of a regime or negotiated tax rates also contributes to non-transparency.

*See generally OECD tax model, reports at* ***www.oecd.org/daf/fa/first_en.htm*** preferential regimes that have been found to be "actually" harmful.

## Theme 2: Tax Administration

### *A. Emerging Issues and Good Practices in Tax Administration*

51. **Professor Arindam Das-Gupta, Gokhale Institute of Politics and Economics, India,** in his presentation, focused on five key ingredients of effective tax administration, drawing on the recent reform experiences and the recent recognition of the importance of proper institutions for effective and efficient tax administration.

52. At the macro-level, he pointed to the crucial role played by the Mission and Vision Statements of the tax administration organizations within the context of a strategic plan. Mission statements set out the goals of the tax administration and provide guidance for operational decisions. Without a mission statement that is understood by all personnel, decisions can be dysfunctional rather than goal oriented. Vision statements, provide a clear, high level, description of what the organization hopes to become by implementing its strategic plan. In order to gauge the extent of mission fulfilment, however, and the degree to which targets are met, measurable performance indicators are needed. After outlining the principles of performance measurement, Das-Gupta then presented a case study on performance measurement.

53. The third issue he discussed was on the key ingredients for successful administration reforms as identified in the writings of some agencies that had extensive experience in rendering technical assistance to revenue administrations in the past. While operational innovations were important – and discussed – experience strongly suggests that reforms will be unsuccessful without the political will to reform at the highest level and strong management capabilities.

54. To fulfil its mission, operational autonomy and flexibility are needed. With this in view, the fourth issue discussed was the design and experience – both positive and negative – of different countries with the institution of autonomous revenue authorities. The final, operational strategy discussed by Das-Gupta was large taxpayer units. He reviewed evidence, primarily from Latin American countries on the efficiency gains that were possible in setting up large taxpayer units. He went on to review the characteristics of successful design of these units.

### *B. Analysing the Institutional Framework of Tax Administration*

55. **Das-Gupta**, **in his presentation on the institutional framework of tax administration**, discussed methods for analyzing the institutional framework of tax administrations and designing tax administrations reform programs. In his presentation, he stressed the importance of institutional strengthening to increase revenue administration effectiveness and efficiency and outlined ten principles of good administration (**Box 4**).

**Box 4: Ten Key Principles of Effective Revenue Administration**

- Banking, the accounting profession, and legal institutions for enforcement and dispute resolution, are crucial for effective tax administration
- Simple taxes depend on simple *base determination procedures* and *few* tax rates. They have little relation to the level of tax rates
- But high tax rates make tax non-compliance and corruption more attractive
- Social benefits from tax administration are much lower than revenue collected. Social costs are much higher than the TA budget
- The current budget of the TA should be linked to its effectiveness. The capital budget should be linked to its strategic plan
- The TA should have sufficient autonomy to employ, pay and allocate human and non-human resources efficiently
- Reforms to curb corruption increase effectiveness and efficiency directly as well—i.e. a "win-win" situation.
- Taxpayer education and assistance are not peripheral activities of the TA—they are as important as enforcement and directly increase efficiency and effectiveness
- The main function of a TA is to gather, use and disseminate information. Computers, while not a panacea, are integral to any TA modernization program
- While well-designed business processes and resource quality improvement are at the heart of effective TA modernization, reform will not be sustainable if institutions are neglected

56. He then presented an outline of an anti-corruption strategy for tax and customs administrations, which was employed in recent technical assistance operations by the World Bank. The latter seeks to address the *motive* for corruption by focusing on basic organizational image and status, positive and negative incentives for officials and supply side penalties coupled with rights protection for taxpayers. It also seeks to address *opportunities* for corrupt behavior through tax simplification, organizational restructuring and fictionalization and setting up institutions for external checks and balances via an independent external audit body and the harnessing of citizens' voice and feedback.

57. Das-Gupta went on to present a framework to evaluate the institutional content of tax administration reform programs which had been used in a recent World Bank study to evaluate the

institutional content of tax and customs administration reform operations by the World Bank in the 1990s. The framework stresses the importance of capacity building and institutional reform to achieve improved performance. While recognizing the paramount importance of high-level political support, simple tax structures and local ownership of reforms, human resource development and infrastructural resources are key to successful administrative reform. Among institutional arrangements, built-in incentives for effective and efficient service delivery are of overriding importance. Effective institutions provide clear and transparent rules to guide policy and actions, promote contestability and competition and institutionalize effective feedback or "citizens voice" to ensure accountable and responsive administration. Finally, clear, non-manipulatable, comprehensive and replicable performance indicators, such as those proposed by the IMF or the Inter-American Development Bank, are needed to measure administrative performance.

**58.** The study of World Bank tax structure and administration reform projects during the 1990s showed that paying greater attention to institutions was needed in World Bank operations, particularly in the area of ensuring transparency and accountability of the tax administrations. Furthermore, their use of performance indicators to gauge the success of reform programs was inadequate.

**59.** Das-Gupta closed his presentation with two case studies, the first of which dealt with performance measurement of tax systems, and the second was on an overview of an on-going World Bank funded tax administration reform program in Latvia, which stressed institutional strengthening.

**60.** The **open discussion** was centered on the practical adaptation of a simplified "carrot" and "stick" incentive package for potentially corruptible tax auditors outlined by Das-Gupta, whereby they were rewarded with any extra revenue from tax evaders they were able to detect and punished if they were detected taking bribes by superiors. Superiors, in turn, were rewarded with an amount equivalent to bribes taken by their subordinates whom they were able to uncover. In the simple situation as outlined above, such a package would deter corruption and so promote taxpayer compliance, raising net government revenue.

## *C. Designing Tax Administration Reform Programs in Developing Countries*

**61.** A tool for "Diagnosis, Strategy Formulation and Project Preparation" for tax administration reform projects, developed by J.B.S. Gill of the World Bank was presented by Das-Gupta in his second presentation. The tool consisted of a series of worksheets covering the following and was illustrated via a detailed case study of a country, called Ixia to conceal its real identity:

- Preliminary performance assessment based on size, effectiveness and efficiency indicators. Among effectiveness indicators, the Silvani decomposition of the tax-gap into registration filing, reporting and collection gaps was presented
- Organizational inputs including the environment, organizational history, and administration resources – all factors that shape organizational strategy
- The organization transformation process encompassing tasks, individuals, formal organization arrangements, and informal culture and norms
- Outputs at the level of the individual, administrative units and the organization as a whole

## *D. Tax Administration: The Japanese Experience*

**62.** **Mr. Masato Ohno, Director, Office of Mutual Agreement of the National Tax Administration (NTA), Ministry of Finance, Japan**, gave a presentation on *Tax Administration: The Japanese Experience*. Japan's experience is noteworthy, especially given its low incidence of administrative corruption, the high marks received by the NTA in periodic taxpayer surveys and the pride NTA officials take in maintaining their reputation of high level of service to taxpayers and revenue collection efficiency. He described the key features of the administrative practice in the NTA. As with most OECD member countries, Japan's reliance on income taxes is high, though the share of direct taxes has decreased from 75 percent in 1990 to 56 percent in 1999 with the value added tax on consumables. Following accepted views on best practices, a clear separation between drafting of tax laws and its administration exists in Japan, with the former being the responsibility of the Tax Bureau of the Ministry of Finance and the latter the responsibility of NTA.

**63.** The NTA, which administers most domestic taxes, enjoys a substantial degree of autonomy over resource employment and deployment decisions, though this autonomy does not extend to fixation of salaries. Promotion is, de facto, seniority based. Nevertheless, the NTA, an external organization of the Ministry of Finance, has salaries, which, at entry level, are 12 percent higher than the general civil service, though salaries are below those in the private corporate sector. Besides salaries, limited use is made of incentive bonuses or bounties for successful tax enforcement actions. Early retirement among NTA officials to take up private practice is the norm. The 58,000 employees of the NTA, consisting mainly of officials recruited competitively directly after high school or university, are organized functionally in a three-tier organization structure.

**64.** Since most employment income earners have their taxes accurately withheld at source, they do not file returns, limiting the number of filed returns to around 20 million (in 1998). Withholding of employment income is performed by 4 million withholding agents. Several types of capital income, aside from business income, are also subject to withholding tax with the number of withholders being slightly lower than for employment income.

**65.** Among the important features of tax administration in Japan discussed by Ohno were the recent introduction of combined audits of income and consumption taxes, leading to both improved enforcement and a decreased burden on taxpayers; the specialization of middle level tax examiners and other officials in a single broad area such as personal income tax audits, corporate audits, or tax collection; and Japan's unique Blue Return System, whereby businesses whose accounts are in keeping with guidelines laid down by the NTA are given certain taxation and administrative benefits in return. While this occasionally leads to problems with non-compliant blue return taxpayers, the system by and large leads to low administrative and compliance costs. The special returns these businesses file are known as blue returns, from the color of the filed-paper returns.

**66.** Among the areas still needing improvement in the NTA is the degree and pace of introduction of automation and the NTA's expertise in meeting challenges from new forms of businesses and financial transactions and growing global integration. The NTA is planning to restructure its organization in early 2001 to reduce areas of overlap of functions. To meet the challenges from e-commerce, a review team (Project Professional Team for E-Commerce Taxation) has been set up. Plans also exist within the NTA to introduce broad-based electronic filing. A major concern that will have far-reaching changes in the near term is the passing of the Freedom of Information Act. Currently, there is an examination of past records and debate within the NTA in order to meet challenges to be posed by the need for greater transparency.

## Theme 3: Key Issues in Tax Policy Design and Reform

### *A. Overview: Issues and Trends in Tax Structures and Tax Policies in the New Millennium*

**67.** **Dr. Chia Ngee Choon of the National University of Singapore** provided an overview presentation on the direct result of the changing world environment attributed to globalization, information technology and increased financing needs of an aging population. The tax structure cannot be examined in isolation and has to be viewed as part of the entire fiscal package. Tax policy as a tool to redistribute incomes from the rich to the poor, particularly to alleviate poverty, continues to play an important role in the new millennium. Traditional criteria used to evaluate whether a tax is a good tax, including the efficiency cost of the tax system, continue to be based on its redistributive role and the ease of implementation and administration.

**68.** Besides raising issues relating to the efficiency and equity implications of the tax structure in the new millennium, Chia also raises other important Y2K fiscal issues and questions, such as (i) could the existing tax structures continue to support the financing needs of public services (in view of changing age structure of population)? (ii) will globalization and Internet technology lead to a change in tax structure, mix and handles? (iii) will tax competition accelerate or decelerate? and (iv) what is the implication on the size of the state?

**69.** Chia first traced the evolution in beliefs about the efficiency cost and redistributive roles of taxes and that the changing tax policy reflects the response to these beliefs. During the 1960s and 1970s, it was thought that taxes did not create any significant excess burden and that the tax structure tends to be redistributive. Policymakers thought that income taxes could be harnessed as efficient tax sources. The tax base for personal and corporate income taxes, however, came under increased scrutiny. Measures were introduced to deal with tax base erosion via tax expenditures, light taxation of capital gains, sheltered capital income (e.g. from pensions) and untaxed imputed income from home ownership. To make income tax more progressive, measures were taken to include taxing capital gains fully, eliminating tax loopholes and broadening the income tax base. In the 1980s, tax policies were influenced by the monetarists, supply-siders and public choice theorists. Improved econometric techniques also led to evidence contrary to earlier beliefs that labor supply and savings are inelastic. On the other hand, improved life cycle consumption models indicated that sales taxes are less regressive than previously thought, implying the need for greater tax structure progressivity. Not surprisingly, the tax reform in the United States in the 1980s reflected these influences and leaned more toward efficiency and less toward redistribution. By the 1990s, tax policy reforms in OECD countries mainly focused on minimizing tax distortions, with a broadening of the tax base and the lowering of the rate. Most countries have also adopted a flatter income tax structure, which tends to be less progressive as compared to a tax structure that is less flat. With the emphasis on efficiency, consumption taxes, particularly the VAT, gained importance both in the developed and developing countries.

**70.** Chia then went on to examine tax issues in the new millennium. Intensified tax competition because of the mobility of capital and skilled labor will lead to tradeoffs between being tax competitive and domestic equity. Highly skilled individuals are more mobile in a globalized economy and more sensitive to differences in effective tax rates, which leads to countries competing by lowering the top marginal tax rate. A lower corporate income tax rate would benefit financial capital, which is likely to be concentrated in the hands of a relatively few wealthy individuals. Besides, the abolishing of withholding taxes on interest payments to non-residents and tax exemption for interest receipts from abroad implies that tax incidence is likely to fall on unsophisticated domestic savers. In the new millennium, if no other fiscal measures are adopted to counter regressivity, the redistributive role of taxes will be compromised.

**71.** The tax mix will rely more on indirect taxes and less on direct taxes. Wealth taxes and taxes on immobile factors, including immobile resources will gain importance. The consumption tax base is likely to be eroded, as e-commerce becomes more important. Other issues that are raised include the possibility of an environmental tax reform. Eco-taxes may improve income redistribution, as environment is seen as a luxury good, so that the tax burden tends to fall on the rich rather than the poor. Other alternatives include the introduction of a "bit tax", which again may improve income redistribution since there is a positive relationship between income and computer ownership, Internet access and credit card usage.

72. The utility of taxes to serve as stabilization tools will be limited, since there is a trend toward convergence in tax policies across countries, resulting in reduction of tax autonomy. Chia also highlighted the growing use of fiscal incentives among developing countries to attract foreign direct investment. She concluded by pointing to the need to look at tax issues within a broader fiscal context and the scope of "partnership" between the public and non-profit sectors in providing a solution to the shrinking tax base and increased financing needs.

## *B. Tax Legislation in Transition Economies*

73. **Easson** began his examination of **tax legislation in transition economies** by outlining the various legislative reforms that become necessary in the process of transiting from a socialist to a market economy. Many of these reforms are also necessary for the transformation of underdeveloped economies. Socialist tax systems were characterized by a small number of taxpayers (most tax being collected from state-owned enterprises), heavy reliance upon enterprise profits taxes and multi-rate turnover taxes, and a relatively underdeveloped tax administration. Since the state had a dual role, as owner and as tax collector, fairness and neutrality were largely unimportant. The actual amount of tax was frequently negotiated and was part of the soft-budgetary constraint facing enterprises. Individual income taxes were of minimal importance, often being restricted to self-employed professionals or imposed only on "excess" wages. Property taxes were almost non-existent.

74. Although tax systems in market economies vary considerably, they also share a number of characteristics that distinguish them from both socialist and underdeveloped tax systems. The most significant differences tend to be the following:

- personal income tax is more important (especially in the more developed economies)
- less reliance is placed on taxes on enterprise profits
- the value added tax (VAT) is the principal consumption tax, supplemented by special excise taxes on a small range of products
- horizontal equity is of greater importance
- the number of taxpayers is substantially greater
- there is greater public awareness of the tax burden

75. An important objective is neutrality. Taxation should not distort economic decision-making or the conditions of competition between enterprises. The tax burden is borne by individuals, either directly as wage earners and recipients of investment income, or indirectly as the proprietors or shareholders of businesses. Consequently, fairness and transparency are important objectives.

76. Transition to a market economy will usually necessitate the following tax reforms:

- replacing the existing enterprise profits tax with a corporate income tax levied on profits computed according to market principles
- introducing a comprehensive personal income tax
- replacing the turnover tax with a VAT, supplemented by a few selective excise taxes
- modifying import and export taxes to conform to WTO rules

77. In introducing these reforms, a number of important policy decisions need to be taken. For example, should the business profits tax apply only to corporations or to all businesses, including partnerships and sole proprietorships? How should dividends and other distributions be taxed? Should there be a single tax rate, or should there be a reduced rate for small businesses? For personal income tax, the principal decisions concern the personal exemption level, the rate structure, the definition of the tax unit, and whether the tax should be 'global' or 'schedular'. In particular, the personal exemption level determines the number of taxpayers. A low exemption limit broadens the tax base and increases revenue, but also makes administration more difficult and costly. For the VAT, the rate structure, exemptions, and the treatment of small businesses need to be decided on. Small business taxation is especially important in less developed countries, since small businesses (and farmers) usually lack the sophistication to keep the records necessary for the proper administration of the VAT.

78. The change to a market-oriented tax system imposes a heavy burden on the existing tax administration. Since the number of taxpayers is often substantially increased, new tax rules and accounting practices must be learnt, taxpayers have to be "educated", fairness and consistency become much more important, and tax avoidance and evasion become more prevalent. These factors should be taken into account in making substantive "design" decisions.

79. Transition to a market economy takes time. The question is — how much time? Under the "big bang" approach, a modern, market-oriented, tax system is implemented immediately — usually based upon a draft provided by one or other of the various technical assistance programs. A policy of

"gradual convergence" is the alternative. Either approach has its advantages and drawbacks, or an examination of the various experiences of transition economies provides no clear answer.

## *C. Issues in the Taxation of Land, Property and Agriculture*

**80.** The presentation by **Professor Rosario G. Manasan** of the **Philippine Institute of Development Studies** began by reviewing economic writings on **issues in the taxation of land, property and agriculture**. These writings suggest that a land tax is neutral and probably progressive in incidence. She observed that in many developing countries, the agriculture sector is taxed through the use of marketing boards; overvaluation of domestic currencies; and agriculture-bias in industrial protection system. In many developed countries, the agriculture sector is considerably protected. As regards to taxing agriculture, export, income and land tax are the possible options. However, they have relative strengths and weaknesses in both economic and socio-political aspects. The income tax has the advantage of progressivity and the ability to serve as a stabilization function. But income tax is generally not a viable option for developing countries because the agriculture sector comprises mainly small or subsistence farmers who do not keep adequate records and are exposed to a variety of risks and uncertainties. Between export and land tax, the land tax is known to have a high administration cost and less efficient. Manasan went on to explain the key issues in taxation of land and property such as the definition of the tax base, establishment of the basis for valuation, determination of rates, assessment procedures, property information and updating, and tax collection.

## *D. Key Issues in Environmental Taxation*

**81.** In a discussion on **Environmental Taxes: Fiscal Restructuring, Design and Implementation Challenges**, **Chia** focused on the basic issues that arise in introducing environmental taxes compared to other economic instruments. Since the early 1990s, the use of market-based instruments in environmental policy has grown considerably. Green tax reform is gaining increasing support, particularly in the OECD countries. Although green taxes are part of fiscal restructuring to internalize environmental externalities, they are the subjects of intense policy debates centered on their design and implementation, and on the question as to whether there is a double dividend. The double dividend hypothesis suggests that substituting green taxes for existing distortionary taxes not only produces a cleaner environment but also reduces inefficiency since most traditional taxes adversely affect work, savings and investment.

**82.** The growing use of green taxes is also due to the need for more effective and efficient environmental rather than command and control instruments. For some countries, the paradigm shift from direct state intervention to market forces has prompted the use of market-based instruments such as green taxes to correct externality. The intensification of tax competition and its impact on the domestic tax base has prompted consideration of alternative revenue sources, such as cost-recovery rules for public enterprises and new taxes such as eco-taxes. Also, many countries tend to overburden traditional tax bases like labor while under-taxing resources. For example, in the EU, fifty percent of the total tax burden falls on labor today as compared to thirty percent in 1960. But only ten percent of the burden is on resources.

**83.** Environmental tax reform is not an ad hoc addition of new taxes to the existing system. An environmental tax reform calls for a comprehensive approach to coordinate tax and environmental policies, with a reorientation of tax structure on 'bads' like pollution from 'goods' like labor effort or capital formation.

**84.** Case studies of the OECD countries and Singapore show the extent of greening in the tax system. Different approaches to greening of the tax system were discussed, highlighting the successes and pitfalls of eco-taxes. These include removing or modifying existing distortionary subsidies and tax provisions in road transport and in the energy sector; a restructuring of existing taxes toward products and activities that are environmentally damaging; introducing new eco-taxes on products that create pollution when they are manufactured, consumed or disposed of; and introducing revenue neutral eco-taxes by lowering other taxes.

**85.** The first dividend of an eco-tax is the economic benefits in generating the incentives to correct environmental externalities. The second dividend, however, depends on other costs of green taxes including direct costs of the regulated sector due to changes in production methods or through the installation of pollution-abatement equipment. Other indirect distortionary costs arise from tax interaction effects; tax planning and tax positioning are also possible. However, cost-reduction through the use of green tax revenues to finance cuts in distortionary taxes is also possible. For the double dividend to hold, cost-reduction from the revenue-recycling effect would have to outweigh both the direct and indirect costs.

**86.** The design of eco-taxes has to take into consideration information and measurement problems, flexibility, the ability to monitor the tax, political feasibility, ethical issues, transition costs, the ease to avoid or evade the tax and other economic policy goals. Trade-offs between equity and incentive effects and the simplicity of taxes are likely to be present. Eco-taxes may also impact international competitiveness and trade performance.

**87.** Implementation challenges include information needed to set the appropriate tax level and the impact on income redistribution, and the robustness of revenue. Since eco-taxes are taxes on "bads", success implies a shrinking tax base, thereby reducing the tax revenue. Furthermore, eco-taxes tend to be pro-cyclical.

88. These challenges tend to limit their adoption in developing countries because of domestic institutional limitations and also because environment is a global public good. Developing countries would rationally choose to free ride and allocate limited resources to growth and development, and focus on raising taxable capacity from traditional revenue sources. However, even in developing countries, eco-taxes are already present to a certain extent in the form of excises on gasoline and petroleum-related products.

## *E. Value Added Taxation*

89. In his presentation on **Value Added Tax, Adhikari** explained issues related to the design and implementation of VAT. He also highlighted new issues in this regard as a consequence of the use and spread of information and communications technology (ICT). He reviewed the standard arguments favoring consumption over income taxes and discussed the advantages of the VAT over sales taxes at different points, including at the retail stage. Turning to design issues, Adhikari reviewed the pros and cons of exclusions of different goods from the VAT base and the choice between zero rating and exemptions: zero rating is more costly in terms of revenue foregone relative to standard VAT treatment and does not reduce regressivity.

90. To prevent regressivity of the VAT, a feature suggested by the experiences of several countries, Adhikari suggested low rates and compensation of poorer groups through an income tax deduction or other incentives for those below the income tax threshold. He went on to describe the choice of the VAT registration threshold, the VAT burden of unregistered and exempt entities and existing developed country estimates of VAT compliance costs, which tend to be moderately high. Also discussed were the special problems of taxing small traders, property sales, financial services and farmers.

91. His discussion of administration issues focused on accounting requirements for firms and an illustrative calculation of the staffing needs of a VAT administration. This was followed by an insightful discussion of the process of managing the introduction of the VAT, in which he pointed to the need to introduce the VAT as a package to compensate low-income households while avoiding over-use of zero-rating and exemptions. Adhikari stressed the need for extensive consultations with policy and opinion makers, potential VAT taxpayers and administrative staff and the need to publicise comprehensively the mechanics of the VAT and obligations of registered taxpayers before its implementation. He also discussed the need for a rigorous audit selection system. He went on to discuss the composition of the team to implement the VAT and the scheduling of staff recruitment and training in the run-up to VAT introduction.

92. Lastly, Adhikari explained that the use of ICT including the Internet has made tax administration difficult, particularly as it relates to business to consumers retailing. Generally, sales tax or VAT is avoided either because mail-order firms do not have to collect such taxes, or because customs officials cannot open all small packages entering the country. More complicated is the case of digital products sold and downloaded from the Internet by individual buyers at the household level. Some ways to tax these electronic sales and consumption will soon be found as work in this area is in progress in the United States as well as in Europe.

## *F. Fiscal Decentralization*

93. **Manasan** in presenting **Taxation in the Context of Fiscal Decentralization** highlighted tax design and administration issues accompanying fiscal decentralization. She first identified the desire for smaller and more responsive governments, the fiscally constrained capacity of national governments to meet growing demand for local services and other country specific developments (such as the break up of the Soviet Union or ethnic diversity in Ethiopia) as providing the impetus on the recent trend toward greater decentralization. After reviewing the difference between de-concentration and fiscal devolution of powers, she then went on to outline efficiency and information-based arguments favoring decentralization.

94. Since assignment of revenue powers should be predicated on expenditure responsibilities, she proceeded to discuss the incentive effects of expenditure decentralization without devolution of revenue raising powers. She followed this by presenting the “decentralization theorem” of normative fiscal theory, whereby responsibility for the provision of public services in an area should be assigned to the level of government and jurisdiction so as to minimize inter-jurisdictional spillovers.

95. In tax assignment, two questions, namely, assignment of tax bases and design and administration of taxes on assigned bases need to be distinguished. After considering several options for sharing of tax powers, Manasan discussed general principles for tax assignment. The general criteria of tax assignment – efficiency, equity and administrative feasibility- suggest that ability-to-pay taxes should largely be assigned to the central level as the responsibility for national redistribution policy is at that level. Taxes based on the benefit principle, fees and charges are appropriate for assignment to local governments.

96. Since the responsibility for administering different taxes could be delegated from one level of government to another higher or lower level of government, tax administration assignment could differ from tax assignment. The general principle for administrative assignment should be the assignment of taxes to the level for which information and collection costs were least. In light of this principle, individual and corporation income taxes, the VAT, interna-

tional trade taxes and natural resource taxes (the latter on equity grounds) should be collected by national governments. In particular, sub-national VAT regimes based on the destination principle are administratively complicated, whereas origin-based taxes are inequitable. Property taxes are therefore a mainstay of local government revenue along with business registration and motor vehicle taxes. Other taxes, for which appropriate assignment depends on specific expenditure responsibilities, include various excises and pollution taxes. The other administrative issue evaluated by Manasan included "piggy-backing" versus multilevel administration of shared bases and the pros and cons of both arrangements.

**97.** Manasan closed her presentation by pointing out that revenue and expenditure assignments typically led to vertical imbalances in practice, necessitating resource sharing, whose principles she briefly examined.

## Theme 4: Country-Specific Taxation Issues

**98.** Presentations made by the ten delegates at the seminar raised different issues reflecting the diversity of experiences and concerns in Asian economies. Reflecting the main theme of the seminar, presentations dealt mainly with international taxation problems. In the training workshop, delegates were divided into 3 groups, to each of which different resource persons were assigned. The group presentations covered seven questions posed by the organizers of the workshop.

### *A. Hong Kong, China*

**99.** Hong Kong, China levies a territorial profit tax on income derived in the country, which excludes dividends, capital gains or interest. It also levies a salary and a property tax. The territorial nature of the profit tax makes determination of the source of profits difficult. The primary test used is the determination of where the profit-making activity takes place, though a number of statutory source rules, including measures that specify payments for the use in the country of a patent, design, trademark, or copyright, exist in Hong Kong, China.

**100.** Administrative initiatives to counter evasion and avoidance include a special unit to investigate complex or substantial evasion and a field audit group to examine business records and visit taxpayers' premises. General and specific anti-avoidance provisions support administrative efforts. Transfer pricing arrangements used by Hong Kong, China taxpayers to avoid local tax often work in conjunction with the territorial tax system. Where profits are shifted out of Hong Kong, China to a connected taxpayer, revenue authorities assess the non-resident party on the basis of a fair percentage of the relevant turnover in Hong Kong, China. Since these attribution provisions do not apply if the connected person is a resident, however, authorities find it difficult to counter schemes in which a resident establishes an offshore operation for transfer pricing arrangements with an entity based in Hong Kong, China. Several avoidance schemes used in Hong Kong, China such as intra-group sales and circular loan arrangements, which are countered by using the general anti-avoidance provision, were also discussed. Among specific anti-avoidance provisions, special rules deny taxpayers depreciation deductions where property is acquired under a sale and lease-back arrangement. Other rules assess foreign associates on all royalties received in respect of intellectual property that was sold to the related foreign party by an entity in Hong Kong, China.

**101.** High on the tax administration's current agenda is a network of double tax agreements with the major trading partners of Hong Kong, China. At present, Hong Kong, China has a number of shipping and aircraft income treaties but only one comprehensive agreement, with the People's Republic of China (technically, an "arrangement" rather than a treaty since it is between parts of the same country). Also planned is the development of appropriate responses to the challenges of e-commerce, which poses particular risks to Hong Kong, China, with its territorial system of taxation, since it is offers opportunities for the disputed re-characterization of income types and, consequently, different source rules. A task force has been appointed for this, though it is most likely that Hong Kong, China will refrain from unilateral solutions until an international consensus on the issues materializes.

### *B. India*

**102.** The Indian report considered issues that have arisen in the context of India's 62 double tax agreements. The exploitation of residence rules where a double tax treaty has special rules for offshore entities as, for example, arises in the context of the India-Mauritius agreement: this treaty results in offshore companies operating in India through Mauritius and paying only nominal income tax in Mauritius. Foreign direct and institutional investors also use the treaty to shelter capital gains from shares in India, as these gains fall solely within the taxing power of Mauritius under the treaty even though Mauritius levies no tax on them.

**103.** Problems of taxing shipping income arise when taxing rights are allocated on the basis of place of effective management or place of registration. Ascertaining place of management can be difficult when management meetings may be held by video or telephone across jurisdictions. However, a place of registration rule leads to tax avoidance via jurisdictions that allow registration for a small presumptive tax on non-resident shipping companies.

**104.** On taxation of profits from aircraft operations, Indian courts treat profits from leasing of aircraft as profits from their operation. India also asserts the right to tax profits where airlines use their maintenance facilities to provide engineering services to other airlines.

**105.** The increasing number of requests to Indian authorities for mutual agreement proceedings (MAPs) with court grants pending resolution for stays of tax collection points to the need to examine the interface between MAPs and the domestic judicial process. There is a difficulty of obtaining information under articles on exchange of information in treaties where domestic laws, such as Switzerland's bank secrecy laws, prevent this.

**106.** The presentation also dwelt on two problems that have arisen in the context of e-commerce and the Indian judicial rulings for the application of permanent establishment rules and on the continued relevance of tax sparing issues.

## *C. Indonesia*

**107.** The Indonesian report focused on four areas of current importance. The first area concerns Indonesia's tax treatment of income from construction projects where there are two important rules. The first rule uses different presumed net gains from payments attributable to construction planning and supervision and from payments attributable to actual construction work. The second is that a non-resident involved in a construction project in Indonesia will be treated as having a permanent establishment in Indonesia from the commencement of the project, with no minimum period of presence in Indonesia required to constitute a permanent establishment. However, this rule is subject to different minimum presence thresholds in Indonesia's double tax treaties and thus primarily applied to taxpayers from non-treaty countries.

**108.** The second area concerns the impending introduction of regulations permitting Advance Pricing Agreements (APAs) to resolve potential transfer pricing problems before they become disputes, after procedural rules for APAs are issued. The third area is the tax treatment of interest derived by a non-resident who, if not governed by treaty provisions, is subject to a 20 percent withholding tax. The double tax agreement between Indonesia and Japan, however, provides an exemption from withholding tax where a debt is guaranteed or indirectly financed by the other state or a financial institution wholly owned by the other government. Some Japanese loans qualify for this exemption, including loans that are deposited in bank accounts outside Indonesia. The arrangements illustrate potential difficulties arising out of unusual treaty provisions of this sort.

**109.** The fourth area is the application of the 'other income' provision in Indonesia's double tax agreements when source and residence countries use different income concepts to apply tax treaties. For example, one country may regard a termination payment as employment income while the residence country regards the payment as 'other' income. And treaty definitions often do not clarify this issue sufficiently.

## *D. Republic of Korea*

**110.** The Korean report concentrated on its adoption of an APA system in 1997. From the perspective of taxpayers, APAs eliminate uncertainty and may be used to provide certainty for up to three years, with an extension for a further three years. For tax administrators, APAs reduce time-consuming and costly examinations and litigation. APA requests are initiated by taxpayers. The tax administration can enter into unilateral APAs, applicable only to Korean authorities and a Korean-based taxpayer, as well as bilateral or multilateral APAs, which will bind Korean and foreign tax authorities and related taxpayers in all affected jurisdictions. Requests for unilateral APAs are rare, probably because a unilateral APA does little to prevent the risk of double taxation. Before agreeing to an APA, the Korean National Tax Service (NTS) reviews the request, possibly with assistance from independent experts. A taxpayer receiving a bilateral APA ruling has two months in which to accept it, failing which the tax authority is free to reopen a transfer pricing examination.

**111.** Reform of the APA system is envisaged for 2001. Specifically, the requirement that taxpayers request an APA prior to the first tax year to which the APA will apply is to be relaxed to the end of the first tax year, since requiring a request prior to a tax year commencing can impose an unnecessary burden on taxpayers. A related change will allow the NTS to retroactively apply an agreed arm's length price for up to five previous years so long as agreement is reached under the MAP with tax authorities in the other jurisdiction to allow for such retroactive application.

**112.** The Korean report attracted interest from jurisdictions that have not yet implemented APA procedures or which are in the process of adopting these procedures. It is expected that several jurisdictions could seek further advice from Korean officials on their experience.

## *E. Malaysia*

**113.** The Malaysian report focussed on a provision to assist in the development of research and higher education teaching skills, whereby Malaysia exempts visiting university lecturers and researchers from tax for visits of up to two years, and which Malaysia proposes to include in its double tax agreements. A number of safeguards to prevent abuse of the exemption is also envisaged.

**114.** The report stimulated considerable discussion. Commentators pointed out that since the exemption's primary purpose is to pardon persons from the Malaysian tax, it is not necessary to pursue the policy through treaties and instead unilateral domestic legislation could accomplish the same end. Moreover, resource persons seriously questioned the efficiency of the measure. In particular, it was pointed out that the effect of the exemption in many instances would merely be to transfer tax revenues from Malaysia to other countries, as in many instances visiting academics would remain taxable in their home jurisdictions. It was suggested that other subsidies, which directly assisted visiting academics rather than benefiting foreign treasuries, such as the provision of research assistants, might be more effective. Finally, the efficiency of only applying the exemption to visitors at public universities was questioned.

**115.** The discussion provided a good example of the application of a rigorous tax expenditure analysis to tax concessions and the way in which this analysis could lead policymakers to choose direct subsidy programs in preference to more difficult programs to target tax concessions.

## *F. People's Republic of China (PRC)*

**116.** This seminar report focused on problems identified with PRC's VAT system after its first ten years of operation. The analysis in the report illustrates approaches that can be considered when countries seek to broaden their consumption tax bases. Many problems are attributable to the incomplete nature of the PRC tax (not applying through the commercial chain) and the fact that, as a consequence of the limited application of the tax, input tax credits are not available for capital acquisition. To the extent the tax cannot be recovered, it remains a burden on exports and a quasi-penalty for investment in capital goods or industries that rely on capital goods. The effect of the VAT is thus to distort the operation of the market by affecting relative prices and impacting on inflation.

**117.** PRC needs to move quickly with its VAT reforms to achieve an economic environment optimal for new investment as a means of countering the continuing effects of the Asian financial crisis. Reforms will also enable PRC to compete effectively when tariffs fall after PRC joins the WTO and to develop the modern economy required for the development of a knowledge and information-based economy. Transitional problems identified if PRC adopts a conventional VAT include, first, a fall in revenue due to the narrowing of the tax base by allowing full input tax credits. A more serious problem is the one-off loss of revenue if credit is allowed for capital assets acquired prior to the adoption of the full VAT. Possible solutions for the latter include rules that would spread recognition of input tax paid on previously acquired assets or allowing only part recognition of input tax credits on such assets. The revenue effects of the former change in the tax base can be addressed through changes to the rate of VAT.

## *G. Papua New Guinea (PNG)*

**118.** The presentation by the delegate from PNG described several features of current international taxing practice in PNG. Residents of PNG are taxable on worldwide income, subject to a foreign tax credit on provision of actual proof of payment of the foreign tax. Three tax regimes can apply to foreign taxpayers carrying on business in PNG. Companies operating through a branch are subject to 48 percent tax on net profits derived in PNG with no withholding or other taxes imposed on repatriated income. A subsidiary is subject to a 25 percent tax on net income and a further 17 percent withholding tax on dividends repatriated to the foreign parent company. Foreign contractors operating in PNG have the option of a simplified withholding tax, based on 12 percent of gross PNG receipts. The tax is remitted directly by the domestic individual or company contracting with the foreign contractor so that no tax return needs to be lodged by the latter. Special rules apply to interest income, management fees and royalties.

**119.** Applying PNG tax provisions to combat suspected transfer pricing has proved difficult. PNG authorities have been unable in many cases to obtain documentation from taxpayers or authorities in other jurisdictions. Lack of trained personnel has also hampered anti-transfer pricing procedures, as has the tendency of courts to give the benefit of the doubt to taxpayers. In response to these factors, PNG has adopted restrictions on the deductibility of lease payments to combat sale-leaseback schemes with related parties, restrictions on the deductibility of management fees, and restrictions on the deductibility of interest payments.

**120.** Tax clearances for international transactions have been used to prevent taxpayers from shifting payments abroad if they have not met all tax liabilities in PNG. PNG is currently involved in negotiations for a major international pipeline project and it is expected that this project, if it proceeds, will raise many additional international tax questions.

## *H. Philippines*

**121.** The Philippines has a large number of operative tax treaties (about 29) and many more pending entry into force or ratification or under negotiation (10). However, a key area of concern is transfer-pricing arrangements. Although the National Internal Revenue Code contains a transfer pricing provision, it has proved almost impossible to apply because ancillary rules needed to apply the provisions have never been promulgated. As a result, there are no guidelines in the Philippines for the determination of an arm's-length price. A revenue memorandum to deal with particular types of foreign trading companies, including Philippine branches and liaison offices of certain Japanese training firms, provides for an arbitrary presumed income. This has the advantage of simplicity but clearly fails to satisfy an arm's-length test. In any case, it does not operate where a treaty applies and the relevant taxpayer does not maintain a permanent establishment in the Philippines. Second, the initial characterization of income is a key step in the determination of taxing rights since different source rules apply to different types of income. This has proved to be problematic. Some taxpayers have crafted technical services agreements so that payments for those services fall within the broad definition in domestic law of royalties – which face a lower final 20 percent withholding tax while services income are subject to a 32 percent tax.

**122.** A third problem is the treatment of income of international carriers. Philippine domestic law imposes a 2.5 percent tax on gross shipping and aircraft billings but this is reduced to 1.5 percent under its treaties. A treaty partner has sought to tax income derived by the partner's international carriers from sources within the Philippines. However, the Philippines will insist on the current shared taxation of international carriers. Other issues raised in the Philippines presentation are tax sparing and issues arising from e-commerce. Regarding the former, tax-sparing articles are not present in recent tax treaties entered into by the Philippines and it has recently agreed to a treaty protocol to remove the article from an older treaty. This is because it has recognized that tax-sparing articles may actually work to the advantage of the residence jurisdiction and not the source country for whose benefit they are notionally adopted.

## *I. Singapore*

**123.** Because of its strategic position and important role as an operational center for multinational enterprises, Singapore faces very real problems of transfer pricing. The Singapore presentation suggested that the model used elsewhere of detailed transfer pricing rules in the tax legislation, while intended to provide clarity, can actually lead to complexity and difficulty in application. So as to not impede economic flows, Singapore has opted instead to use a general anti-avoidance provision to deal with transfer pricing arrangements. The OECD transfer pricing guidelines are used by Singapore as a reference for transfer pricing re-constructions.

**124.** Singapore is also keen to see the growth of e-commerce within its territory and is committed to ensuring that its tax rules do not inhibit its growth. The tax administration is monitoring international developments and as tax rules on electronic commerce are generally accepted internationally, they are likely to be adopted in Singapore as well. Meanwhile, the Inland Revenue Authority of Singapore has a series of tax guidelines to explain how current tax laws apply to electronic commerce transactions (which are available on the IRAS web site at **www.iras.gov.sg**).

## *J. Taipei,China*

**125.** The presentation by Taipei,China focused on new income tax incentives and tax reforms for industrial development. One of the most important is a company and shareholder tax integration system whereby dividends from domestic companies are fully exempt from tax in the hands of shareholders, but a ten percent undistributed earnings income tax applies to profits retained in a company. One effect of the integration system is to reduce the maximum tax on income derived through companies from a total rate of 55 to 40 percent, the highest individual marginal rate.

**126.** Taipei,China has also extended, for 10 more years, tax incentives intended to assist industrial upgrading while changing incentive rules to increase their effectiveness. A tax credit of between 5 and 25 percent of expenditure is provided for outlays on R&D and personnel training. In addition, if these expenses exceed the average expenditure on these items of the previous two years, a further tax credit of fifty percent of the excess is available. Another tax credit is available for either twenty percent (in the case of corporate investors) or ten percent (in the case of individuals) of the cost of shares in companies in "newly emerging, important and strategic industries" provided the shares are held for at least three years after acquisition. The tax credit rate will be lowered annually. Alternatively, if shareholders waive their right to the tax credit for investments in qualifying companies, the company will qualify for a five-year exemption from corporate income tax.

**127.** To encourage mergers and consolidations that are viewed as economically beneficial by the Ministry of Economic Affairs, a surviving or new company following a merger or consolidation may continue the tax exemption enjoyed by one of the predecessor companies, provided it continues a qualifying business. International tax issues covered in the presentation included the amendment of the transfer-pricing rule in the income tax law so it reflects the OECD approved methods for establishing arm's-length prices. To use the transfer-pricing provision to adjust a taxpayer's income, tax administrators must first obtain approval from the Ministry of Finance. The use of advance pricing agreements has also been proposed.

**128.** Taipei,China officials apply current tax rules to e-commerce transactions. It is committed to working with foreign governments to ensure no new taxes are adopted that may discriminate against e-commerce. The tax administration is seeking to make greater use of technological advances to improve its tax administration including the use of the web and e-mail to communicate information, online filing, and payments via ATMs and other methods.

## *K. General Discussion*

**129.** Discussions on country presentations at the seminar were focused on issues needing discussion by resource persons. Discussion was mostly on the six issues raised in presentations by resource persons and delegates. As discussed above, a number of participants also expressed interest in the APA system introduced in Korea in 1997.

**130.** A second topic, which attracted attention was related to issues raised by e-commerce and, in parallel, the use of new information and communication technology to improve taxpayer services. Several participants (Taipei,China, PNG, Indonesia) expressed concern about Internet security issues particularly with respect to electronic filing of returns. The delegate from Taipei,China reported that these concerns had led to the limited use of electronic filing by taxpayers (500 returns being filed in the latest year) despite it being introduced in 1998. Singapore suggested that, despite risks, potential costs were outweighed by administrative and taxpayer benefits. Their use of incentives to encourage e-filing had led to 30 percent of taxpayers in Singapore filing through the Internet. On the other hand, the delegate from India reported that a new Information Technology Act had been passed earlier this year in India, which, among other provisions, provided for recognition of digital signatures. A participant also pointed to the importance of continual training to keep pace with international developments in information technology.

131. The third topic, raised by several participants, related to tax incentives. The delegate from Taipei,China raised the issue of competitive incentives provided by Singapore, sometimes incorrectly reported by some potential foreign investors. Singapore pointed to the same problem with respect to Taipei,China's incentives. Among different incentives, the potential for abuse of R&D credits (Singapore), the scrapping in 2001 of tax holidays termed "tax borne by government" in Indonesia, the problem of ministerial pressure from spending ministries in providing concessions (India), and the need for a level playing field for both resident and foreign investors (Hong Kong, China) were discussed. The issue of coordination problems arising from administration of incentives by different ministries was also raised (PNG). The efficacy of regional development via infrastructure as an alternative to investment was also suggested (Philippines).

132. The discussions of the provision of tax incentives and the fourth issue on advance rulings were largely prompted by the valuable OECD presentation on harmful tax competition. On secret or confidential advance rulings being deemed a form of harmful tax competition by the OECD, Singapore raised the issue of taxpayer assistance via informal clarification on specific issues to taxpayers. These, while not explicitly named as such, amounted to advance rulings. Some participants (PNG and Indonesia) raised the potential for misuse of advance rulings with one participant suggesting the use of administrative circulars rather than individual rulings. Krever responded to this concern by suggesting that costs through abuse could be outweighed by the information gained from petitioners on new tax avoidance schemes.

133. The fifth issue discussed centered on transfer pricing, with interest being expressed in the Minimum Asset Tax as an anti-avoidance measure (Malaysia), the difficulty of applying APAs to software imports (India), and the possibility of trained administrators and strict enforcement of domestic laws substituting for detailed transfer pricing legislation. Appreciation was also expressed for the important work done by the OECD in documenting and providing training relating to different aspects of international taxation (Korea).

134. The sixth issue, which attracted discussion and support throughout the seminar and on which there was consensus among all participants in the seminar – resource persons and delegates alike – was on the need for an improved institutional framework for regional and international cooperation in tax matters. Several delegates also proposed the ADB as a possible vehicle for strengthening regional cooperation.

## *L. Country Specific Issues on National Taxation*

135. Participants for the workshop were divided into three groups comprising: Indonesia, Lao PDR, Myanmar, Philippines and Thailand (Group A); Bangladesh, Bhutan, Nepal, Pakistan and Sri Lanka (Group B); and Cambodia, the Maldives, Mongolia, Tonga and Viet Nam – the group with the greatest heterogeneity (Group C).

136. The first topic for discussion was in regard to **key reform measures of existing tax regimes to maximize revenue and economic efficiency**. The group views on this topic reflected the diversity in levels of sophistication and economic problems of the different groups. Group A identified administrative measures to bring about simpler and more efficient administration including reform of payment systems, faster refund procedures, the use of EDI (electronic data interchange), introduction of simplified assessment procedures akin to Japan's blue return schemes coupled, however, with heavier penalties. Administrative reforms proposed were large taxpayer units and functional reorganization of tax administration. Tax reforms proposed were base broadening for individual income and the VAT particularly by way of rationalized, targeted, tax incentives and by exploring alternative policies such as improved infrastructure.

137. The focus of Group B's presentation was throughout on enhancing enforceability and preventing erosion or increasing the tax base. The group outlined key reforms undertaken by different countries to increase effectiveness and efficiency of national tax systems. Tax reforms ranged from introducing or strengthening indirect and direct tax legislation in Bhutan to the introduction of a GST in Sri Lanka and the abolition of several tax incentives in Nepal. Administration reforms reported were equally diverse, ranging from increased computerization (Bhutan, Pakistan and Sri Lanka) to expansion of withholding tax (Pakistan) to outsourcing of pre-shipment inspection (Bangladesh) and, selectively, auditing (Nepal), the introduction of a large taxpayer unit (Bangladesh) and implementation of a formal HRD program (Bhutan).

138. Group C's presentation mainly used the Cambodian experience to illustrate their reform recommendations which included base broadening (via a reduced personal income tax threshold and the introduction of the VAT), reducing tax induced distortions (by limiting exemptions and moving from multiple rate taxes to single rate taxes) and administrative

strengthening by focusing on automation, improved procedures and strengthened management and organization.

139. The second item for discussion was the **views of participants on new taxes such as environmental taxes**. Views expressed by different groups were as diverse as on the first topic. Group A expressed opposition to environmental taxes as falling too heavily on the poor and suggested the use of legal restrictions and direct inducements instead. Group B, while generally opposed to new taxes suggested a tax on idle urban land (Nepal and Pakistan). Group C pointed out that several environmental taxes, such as fuel, transportation and natural resource taxes already existed in some group countries and proposed a marine tax (Maldives) and a tax on coal which is used extensively for space heating (Mongolia).

140. The third discussion topic concerned participants' **views concerning promotion of cost recovery and participation in infrastructure, utilities and social services to reduce public expenditures**. Group A was of the view that user charges could be used (e.g. for roads) if an alternative was available to citizens. Within Group B, Nepal reported on existing and proposed use of BOOT projects for power and roads, privatization of telecommunications and private participation in water supply utilities in Kathmandu. Group C approved of the suggested expenditure reduction measures and pointed out that they are already in use, particularly via privatization.

141. The remaining topics complemented proceedings at the seminar and also several papers in the workshop. The fourth topic related to **issues and experiences with tax treaties and taxing foreign entities**. Both Groups B and C pointed to their limited experience with foreign tax treaties, with four countries (Bhutan, Cambodia, Maldives, Tonga) having no treaties at all.

142. Group A discussed three problems arising in member countries, particularly Indonesia and the Philippines in taxing foreign entities. These included contract manufacturing, whereby a foreign company provides capital but contracts with a subsidiary to undertake operations for a small share of profits. This permits the foreign company to avoid having a Permanent Establishment (PE). PE problems arise when services are provided by offshore consortia to related parties and when hotel management contracts are awarded by local companies to foreign providers.

143. The fifth issue was the experiences and **views of participants concerning tax incentives particularly for ICT** (Information and Communication Technology) sector development. With the exception of Viet Nam, there was general opposition to using tax incentives, with participants suggesting the use of non-tax measures and pointing to the likely lack of effectiveness, negative revenue effects and facilitation of evasion, avoidance and corruption. Viet Nam suggested that incentives could have positive effects on economic activity. Resource persons expressed scepticism on this and pointed to the difficulty in measuring these economic effects. Viet Nam and Group B countries described continuing and new concessions in their countries with Pakistan, in particular, reporting a package of concessions for the ICT sector.

144. The sixth item was the **views of participants on avoiding genuinely harmful tax practices**. These practices were generally opposed with Groups A and C suggesting the need for broad-based international cooperation via tax treaties, exchange of information and regional cooperation. Regarding the OECD initiative on harmful tax competition, Group A suggested that the organization was not sufficiently representative. While the UN is more broad-based, it is perhaps not equipped to coordinate efforts to curb such competition. Group C pointed out that harmful tax practices were not limited to the international tax arena and could occur domestically as well.

145. The final discussion topic focused on participants' **views on the utility of regional and international initiatives** in promoting information and knowledge sharing and policy cooperation among Asian and Pacific countries. There was general approval of enhanced regional cooperation as in the seminar. Group A approved of a regional tax forum. Group B suggested five areas for regional cooperation including multilateral tax agreements, tax law harmonization, exchange of information and administration cooperation via training, secondment and ensuring compatibility of automation platforms. The group also floated the idea of the formation of an Asian and Pacific Association of Tax Administrators with possible initial seed money from the ADB and a South Asian chapter headquartered in Thimphu, Bhutan. Group C expressed broadly the same views as Group B (except regarding the specific South Asian suggestion).

## Concluding Session

146. In the closing session, key conclusions highlighted by Adhikari covered the need for further examination of problems raised by e-commerce, including the issue of Internet savings and its implications; the importance of administrative strengthening by the use of well defined mission statements and through increasing use of information technology; tax treaties and their possible alternatives; tax incentives for ICT development; and concerted efforts for the avoidance of genuinely harmful tax competition. He also highlighted the recommendation put forward by the conference delegates that there is a need to broaden the scope of regional policy cooperation and dialogue between countries through the establishment of an appropriate institutional framework in the region. Finally, Adhikari urged the conference delegates to promote networking among themselves and organize briefing seminars for their colleagues on the key issues and conclusions of the 2000 Millennium Tax Conference.

147. Chua gave his closing remarks on behalf of the organizers. He highlighted four important messages that emerged from

the conference. First, be practical and reasonable rather than over-ambitious. In other words, as Lodin said, 'to tax what you can practically tax will be a more important principle than what in theory ought to be taxed.' Second, we must respect civil society. In the area of taxation, it is more than that. The 'public' are tax payers and therefore your customers. Public consultation and education are extremely important. Third, because of the globalization and the rapid advancement of ICT, tax bases are increasingly becoming more mobile. Again quoting Lodin, 'Countries will have to rely more on source taxation (than residence taxation) as it will become crucial to collect tax while the tax base, and thus the money, is still under control within the jurisdiction.' Next, he pointed out that it is important to become aware of the problems before they become acute, in order to get enough time to find appropriate solutions. In closing, he expressed his thanks to all the sponsors, collaborators, resource persons and the delegates and their governments for their participation.

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  29 May - 7 June 2000, Tokyo, ESS No. S27/00
- **Fighting Urban Poverty**
  26-29 June 2000, Shanghai, ESS No. S28/00
- **Public Expenditure Management: Training-of-Trainers Program**
  3-11 July and 3-12 October 2000, Tokyo, ESS No. S29/00
- **International Finance Seminar**
  9-13 October 2000, Singapore, ESS No. S30/00
- **Pacific Public Management Executive Program (PPMEP)**
  **Module 2 : Managing Continuous Quality Improvement**
  4-12 September 2000, Brisbane, Australia, ESS No. S31/01
- **Poverty Reduction Issues**
  1-10 November 2000, ADB, Manila, ESS No. S32/01
- **Millennium Tax Conference**
  20-29 September 2000, Tokyo, ESS No. S33/01
- **Public-Private Partnerships in Health**
  30 October - 3 November 2000, Ayuttaya, Thailand, ESS No. S34/01