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Tax Conference

1999 Seminar on International Taxation, Tokyo

Executive Summary of Proceedings

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Macroview

[¶] References are to paragraphs.

Increasing **mobility of capital** has encouraged enterprises and investors to develop global strategies. As a consequence, the physical location of management of multinational enterprises (MNEs) is much less important, and is making monitoring more difficult. **Cyberspace** created by the "big bang" expansion of the Internet has presented many problems in the application of tax norms to which tax officials have been accustomed. [¶ 2]

Privatization too inevitably erodes a government's traditional tax base and requires a more rigorous and inventive system for the administration of corporate tax. [¶ 5]

Highly progressive tax structures have proven ineffective in promoting a more equal distribution of income, while tending to discourage growth and driving economic activities underground. Instead, it is believed that social objectives are better served by open and direct public expenditure programs, while tax policy should concentrate solely on revenue-raising objectives, rather than social engineering. This shift has led to a move **toward proportional tax structures** and a greater reliance on indirect rather than direct taxes. [¶ 6]

Taxation of land and agriculture sector in many developing countries continues to be particularly difficult in terms of both policy formulation and implementation. [¶ 8]

The **rules of international tax** form part of the domestic tax law of each nation. Primary objectives of international taxation are to balance the interests of nations as regards their tax jurisdiction and to prevent international tax evasion. A tax treaty, as it applies to international transactions, might modify a nation's domestic tax law. The major impact of tax treaties is to limit a country's jurisdiction to tax as a source country. [¶ 11, 12]

However, outcome of treaty negotiations may be affected by political considerations and, consequently, may not necessarily result in the most rational system of taxation to be applied to international transactions. [¶ 13]

Currently **accepted international norms** are:

- the source country has primary right to tax active income
- the residence country has the primary right to tax investment income (essentially dividends, interest, royalties)
- this is achieved by the source country accepting a rate limit on the level of taxation of such income
- the residence country has the responsibility to provide relief from international double taxation
- the allocation of income among nations in related party transactions is achieved through the 'arm's-length' principle [¶ 15]

According to the OECD, an increasing number of MNEs have annual turnovers in excess of US$100 billion, and approximately half the world's trade today is represented by **intra-firm transactions**. It is increasingly more difficult today to identify the headquarters of an MNE, as the modern MNE is truly an international organization that is geographically mobile and highly responsive to change. [¶ 17]

Similarly there are increases in cross-border portfolio investment by individuals, particularly collectively through retirement and other investment funds. [¶ 18]

Electronic commerce means that global business is no longer the exclusive domain of MNEs. Even small businesses can effectively engage in cross-border transactions. [¶ 19]

With the rise in international trade in services, there is an increasing separation of the place where the work is performed and the place where the product of the work is utilized. [¶ 20]

The overall impact of e-commerce on tax systems may turn out to be limited. E-commerce may place enormous

strains on certain aspects of consumption tax bases and will test the boundaries of some important international income tax concepts, such as **source of income** and **permanent establishment**. [¶ 22]

Nevertheless the destination principle is expected to apply in the ordinary way to cross-border sales of tangible goods over the Internet. As these goods will still have to pass through customs procedures, so the ordinary rules on imports and exports can apply. [¶ 23]

It is also expected to apply in the ordinary way to cross-border supplies of services over the Internet. Existing rules in consumption tax laws creates a bias in favor of consumers acquiring services from foreign suppliers (rather than domestic suppliers). The Internet makes the acquisition of services from foreign suppliers much easier, thereby exacerbating this bias. [¶ 24]

The **supply of digital products** over the Internet raises the most significant issues in the application of consumption taxes. Broadly, these products involve sound, data or visual graphics that can be captured in digital form and delivered over the Internet, such as music, books, software, video and film recordings. The first difficulty is identifying whether a supply is a domestic supply or an export. As a means of verifying credit card payment for online orders, customers are often required to provide the billing address for the credit card, which could be used to determine whether the supply is a domestic supply or export. The taxation of online imports, as they do not pass through customs or postal authorities, as in the case of an ordinary supply of tangible goods, is more problematic. Main options for dealing with this case include the "bit" tax and surrogate taxation of financial transactions used to pay foreign suppliers. [¶ 25]

At what point does an **electronic presence** constitute a permanent establishment? A leased computer server or leased space on a computer server might constitute a permanent establishment, particularly where it took orders and accepted payment details. However, a web-page on a server that merely advertises products might be excluded from the definition of permanent establishment if it uses the facilities solely for the display of goods. Even if a server can constitute a permanent establishment, then this can be simply avoided by using a server located outside the jurisdiction. [¶ 27]

Today, virtually every substantive provision of income tax has a potential international application. Thus, differences in any aspect of the design of the income tax can give rise to conflicts. [¶ 30]

While substantial commonality exists in the design of other taxes, such as VAT and customs duties, this is not the case with **income tax**. In particular, a tax treaty may exclude or limit a source country's right to tax. Thus, the basic approach involves the interposition of a tax treaty between the national income tax laws of the two countries as the means of coordinating those laws. [¶ 31]

Many international transactions are genuinely global involving several countries, whereas tax treaties, to date, are purely **bilateral in nature**. There are difficulties in applying tax treaties in so-called "triangular cases". For instance, differences in tax treatment may arise depending on whether the foreign investor is a resident of a treaty or non-treaty country. But in the global economy, such differences do not seem to be justifiable and may be difficult to sustain because of the prevalence of treaty shopping. [¶ 32]

A novel alternative could be the negotiation of a multilateral tax treaty but the more parties required for agreement, the less (not more) detailed the agreement will tend to be. [¶ 34]

A final alternative is the development of **model income-tax laws**. Instead of insisting on a single approach, the development of model income tax laws would allow countries to design the income tax as they chose, but in doing so they would be made aware of the **compatibility issues** that arise with the design choices they make. Such a process would identify the design options and indicate the compatibility issues that may arise for each option. [¶ 35]

Tax incentives are still used to encourage foreign direct investment. Because of tax planning though, the revenue foregone from tax incentives may be much greater than estimated. Tax competition may also become irrelevant in relation to highly mobile capital investment. [¶ 36]

Generally, a nation's assertion of its jurisdiction to tax can be based on **personal or economic attachment** to a territory. Residents are taxed on worldwide income (personal attachment) and non-residents are taxed on domestic source income only (economic attachment). Some countries tax only on the basis of economic attachment, which is referred to as the territorial basis of taxation. [¶ 38, 39]

Interestingly, while source is accepted as a basis of taxation, there is no universally accepted set of rules for determining the source of income. **Source rules** are commonly used for particular classes of income, such as the sale of goods, provision of services, dividends, interest, royalties, rental income and capital gains. [¶ 41, 43]

The discussion of tax competition should not be confined to so-called "harmful" cases. There is also a more general nature to tax competition, namely a conflict between border-less economic activities and tax systems under jurisdiction of each country, which should be kept in mind too. Tax competition makes it more difficult for each country to choose its tax policies without taking into account the reactions of other countries. [¶ 44]

lnternational coordination of tax systems may be difficult, (possibly presently impossible), and so **administrative cooperation** is a more realistic objective. The importance of the exchange of information among tax administrators to deal with e-commerce transactions and innovative financial instruments should be considered further. [¶ 46]

In nascent systems, different collection and enforcement procedures often apply to different imposts, thereby resulting in unnecessary overlapping and duplication of administrative effort. The recommended approach is clearly to **centralize the tax administration**. [¶ 48]

A developing country government needs to ensure that the design of its fiscal laws is appropriate, and that adequate tax administration resources exist. [¶ 50]

Also recommended is the simplification of the income tax rate structure, with the number of income tax rate bands or brackets (including a zero rate) being reduced. This usually results in a broadening of the income tax base. [¶ 51]

Governments should be **active in seeking regional so-**

lutions to international tax issues, particularly the harmonization of tax treaty policies in the region to avoid tax competition and regional mutual cooperation in administration, including, even the joint audit of taxpayers. [¶ 52]

Greater reliance has to be placed on withholding taxes, especially at source. At the appropriate time, self-assessment must also be considered for introduction. [¶ 53]

As to the introduction of a VAT at a single rate of 10 per cent on the destination principle, global experience recommends that exemptions have to be kept to a minimum. [¶ 54]

Introduction

1. **Dr. R.B. Adhikari, officer-in-charge** for the 1999 Tax Conference, greeted the delegates and resource persons, and introduced the head table and the conference agenda. In his opening speech, **Mr. N. P. Samarasinghe, Director, Japanese Representative Office, ADB, Tokyo**, extended a warm welcome to everybody at the Tax Conference. He said the ADB has been holding the tax conference over the past eight years in recognition of the importance of skilled human capital for economic development and improving economic welfare of the people. Every year the tax conference brings together senior tax officials and eminent tax experts to discuss emerging issues in international as well as national taxation policy and administration. The tax conference provides a forum and a training opportunity to cover the theoretical and practical aspects of taxation, through a two-day seminar, and a five-day training workshop. It provides a unique opportunity to discuss new challenges in taxation as they evolve as a consequence of the globalization of markets and the localization of decision making and administration. He pointed out that the Tax Conference has become an important event in the calendar of tax policymakers, tax administrators and taxation experts and academicians. It has been successful in many ways, as judged by the beneficiaries and the sponsors of the conference. The key factors to the success have invariably been the participants and the resource persons, the quality of discussion on key issues, and the richness of knowledge disseminated. He therefore stressed that this trend and practice would continue this time also. Mr. Samarasinghe highlighted that the Tax Conference is one of the recipients of the **Japan Special Fund**. Since last year, ADB Institute has joined ADB in the conduct of the Conference with both intellectual and financial contributions. The Tax Conference has benefited enormously from this collaboration and partnership. For this, Mr. Samarasinghe, on behalf of the ADB thanked the Government of Japan, and the officials behind the scenes without whose support the tax conference would not have been possible. He particularly thanked his colleagues in the International Tax Affairs Division and Tax Bureau in the Ministry of Finance, Japan, for their assistance.

2. **Mr. Yukitoshi Kimura, Deputy Director General, Tax Bureau, Ministry of Finance, Japan**, gave welcome remarks on behalf of the Ministry of Finance. He said that tax officials were facing many challenges, which have many common features. On the domestic side, most government officials have to deal with sluggish economies, a rapid change of industries, and the demand to improve taxation systems. On the international side, the accelerating process of globalization of trade and investment is changing the relationship among tax systems of countries. Increasing mobility of capital has encouraged enterprises and investors to develop global strategies and made the physical location of management much less important, thus making monitoring difficult. Furthermore, he said that cyberspace created by the explosive expansion of the Internet has presented many problems in the application of tax norms to which tax officials have been accustomed.

3. **Mr. S. B. Chua, Director, Capacity Building and Training, ADB Institute, on behalf of the Dean, Dr. Masaru Yoshitomi**, gave his opening remarks. First, on behalf of the organizers, the ADB and the ADB Institute, he welcomed the chief guests, resource persons and the country delegates to this Tax Conference. He then highlighted that the tax conference had two components: an international taxation seminar from 7 to 8 October; and a training workshop on taxation from 11 to 15 October 1999.

4. In providing the background and the rationale of the tax conference, Mr. Chua pointed out that on one hand, taxation is the instrument with which a government mobilizes resources for promoting economic growth and social development, and on the other hand, taxes provide key signals that affect private resource allocation decisions.

5. He highlighted that the paradigm in economic thinking has shifted in recent years so that it is now generally believed that decentralized decision-making by economic agents tends to produce superior performance compared with decision making in economies under strong government control. In line with this thinking, many developing countries are moving toward leaner and more efficient governments. In the extreme, some developing countries are dismantling their central planning apparatuses and turning their economies over to market allocation, while others are undergoing deregulation and opening their domestic markets to international competition. Such transitions affect the existing tax bases and traditional methods of tax collection and require some fundamental changes. For example, privatization inevitably erodes the government's traditional tax base and requires a more rigorous system for the administration of corporate tax.

6. A second shift in economic thinking that has had a direct bearing on tax policy is that highly progressive tax structures have proven ineffective in promoting a more equal distribution of income while tending to discourage growth and driving economic activities underground. Instead, it is believed that social objectives are better served with public expenditure programs while tax policy should concentrate on revenue-raising objectives. This shift has led to a move toward proportional tax structures and a greater reliance on indirect rather than direct taxes. It is also believed that improved tax administration is essential to keeping tax rates low and ensuring a fair distribution of the tax burden.

7. Mr. Chua said new issues and challenges have emerged in international taxation largely due to the globalization and integration of financial markets and financial flows. These include, for example, the issue of harmful tax competition; counteracting international tax evasion and avoidance; international tax dispute settlement systems; and taxation of electronic commerce. While there are proposals for multilateral approaches to international taxation issues, these are still new and not sufficiently clear to developing countries. Perhaps, many of the international taxation issues could also be addressed at the regional level. There are indeed regional initiatives such as ASEAN, APEC and SAARC, and also sub-regional initiatives, including, for example, Greater Mekong Subregion; Indonesia, Malaysia and Thailand - Growth Triangle; and Central Asia and People's Republic of China.

8. The Asian financial crisis has added further challenges to national taxation authorities, Mr. Chua noted. On one hand, there is the need for giving some flexibility to the corporate sector to recover from the financial crisis, and on the other, the tax base has shrunk due to problems in the corporate sector. Equally pressing is the need to restore or maintain fiscal discipline to ensure macroeconomic stability. The new challenges to governments of developing countries are therefore to strike a balance between all these pressing needs; for example, maintain social expenditure, provide social safety nets to those individuals who suffer most in economic crisis, and at the same time maintain fiscal discipline to sustain macroeconomic stability. Furthermore, taxation of land and agriculture sector in many developing countries continues to be difficult in terms of both policy formulation and implementation.

9. Set against this background, he highlighted that there were two main objectives of the conference. The first was to provide a forum for an exchange of views and experiences on current trends in international taxation through an International Taxation Seminar, which would also encourage mutual understanding and cooperation among tax policymakers and administrators. Second, it was to conduct a Training Workshop on Taxation for tax officials, which would assist them in deepening their understanding of the current trends in taxation policies and administration procedures in developing countries and allow utilization of this information in policy design and implementation.

10. Six papers on evolving issues in international taxation prepared by resource speakers and nine country papers on issues and experiences in international taxation of the participating countries by respective country delegates were presented and discussed at the Seminar. A summary of the main issues raised and discussed is presented below.

Key Issues in International Tax Today

11. An overview of International Tax Issues was presented by **Professor Tadatsune Mizuno, Faculty of Law, Hitotsubashi University, Japan**. He outlined the historical development of international tax rules. This provided a very important starting point for one of the central themes of the seminar, namely the impact of globalization on international tax. Professor Mizuno observed that there is no such thing as an international tax law. Rather, the rules of international tax form part of the domestic tax law of each sovereign nation. Professor Mizuno concluded that international taxation is a "system of the domestic tax law to be adopted for international transactions." Importantly, he noted that a tax treaty, as it applies to international transactions, might modify a nation's domestic tax law. The major impact of tax treaties is to limit a country's jurisdiction to tax as a source country. Thus, its domestic tax law as modified by its tax treaties constitutes a nation's international tax rules.

12. Professor Mizuno stated that the primary objectives of international taxation are to balance the interests of nations as regards their tax jurisdiction and to prevent international tax evasion. A balancing of the interests of nations implies that rules must exist for the elimination of double taxation. He questioned how this could be achieved when international tax rules are part of the domestic law of nations. He emphasized the importance that sovereignty has played in the design of national tax rules. As a result, with increasing cross-border transactions, he observed that "overlap of [tax] jurisdiction rather than eliminative jurisdiction is often found in actual cases". This means that there is "the need for a new system for coordination and cooperation between governments."

13. Professor Mizuno discussed further the role of tax treaties. The useful influence of the OECD Model Tax Convention and the UN Model Treaty on the broad design of tax treaties was highlighted. However, he emphasized that a tax treaty is the product of bargaining and negotiation between countries. Thus, the outcome of treaty negotiations may be affected by political considerations and, consequently, may not necessarily always result in the most rational system of taxation to be applied to international transactions.

14. Professor Mizuno concluded his paper by highlighting some of the problems for international taxation today. Namely, (i) electronic commerce, particularly the fact that economic activity today does not necessarily require a physical location; (ii) tax competition; (iii) tax havens; and (iv) the lack of an effective mechanism to resolve cross-border tax disputes. These problems proved to be important topics for further discussions during the course of the Seminar.

15. **Professor Lee Burns of the Faculty of Law, University of Sydney, Australia** agreed with Professor Mizuno that there is no such thing as an international tax law. He argued, though, that there are certain international norms found in the

tax laws of most countries that effect a basic sharing of revenues. These norms are (i) the source country has the primary right to tax active income; (ii) the residence country has the primary right to tax investment income (essentially dividends, interest and royalties); which is achieved by the source country accepting a rate limit on the level of taxation of such income; (iii) the residence country has the responsibility to provide relief from international double taxation; and (iv) the allocation of income among nations in related party transactions is achieved through the 'arm's length' principle.

16. Professor Burns observed that these norms were the foundation principles on which model tax treaties were developed but now form part of the domestic tax law of many countries. He also elaborated on the current global environment in which a nation's international tax rules have to operate.

17. First, MNEs can operate without regard to "national frontiers". They have operations in more countries than ever before. According to OECD, an increasing number of MNEs have annual turnovers in excess of US$100 billion, and approximately half the world's trade today is represented by intra-firm transactions. With rapid transportation and improved communications, many decisions are taken in the field. As a result, it may be more difficult today to identify the headquarters of an MNE. In short, the modern MNE is a truly international organization that is geographically mobile and highly responsive to change.

18. Second, there has been a dramatic increase in cross-border portfolio investment by individuals, particularly collectively through retirement and other investment funds. This has been accompanied by the development of innovative financial products that give investors considerable flexibility in the investments that they can make.

19. Third, the rise of electronic commerce has two important implications for international business. Through the use of a web page a business can promote its products in another country without necessarily having any physical presence in that country. It may be that the traditional notion of the representative office becomes a thing of the past for many businesses. Electronic commerce means that global business is no longer the exclusive domain of MNEs. Even small businesses can effectively engage in cross-border transactions.

20. Fourth, there has been a dramatic rise in the international trade in services. It is also the case that many types of high value professional services can be performed anywhere, so that there is an increasing separation of the place where the work is performed and the place where the product of the work is utilized.

21. The application of the existing international tax rules in this new global environment was the subject of subsequent papers and discussion during the Seminar.

Electronic Commerce and Taxation: A Summary of the Issues in the Asia-Pacific Region

22. **Professor Rick Krever, School of Law, Deakin University, Australia** started his paper by observing 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. Were one 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. Professor Krever expressed the view that the overall impact of e-commerce on tax systems may be limited. He recognized that e-commerce may place enormous strains on certain aspects of consumption tax bases and will test the boundaries of some important international income tax concepts such as source of income and permanent establishment.

23. He considered the implication of e-commerce for consumption and income taxes for three broad categories: (i) the remote selling of tangible products; (ii) the remote delivery of services; and (iii) the selling of digital products. Professor Krever argued that, with the exception of the delivery of digital products, e-commerce poses no new issues in the application of consumption taxes. The destination principle is expected to apply in the ordinary way to cross-border sales of tangible goods over the Internet. The goods will pass through customs procedures, so that the ordinary rules on imports and exports apply. Professor Krever raised a potential timing issue in the application of consumption taxes to domestic sales of tangible goods over the Internet. Ordinarily, the timing rule is earlier than the time of payment or time of invoice. The issue raised by Professor Krever is whether an "electronic" invoice is within the legal definition of invoice in consumption tax laws.

24. The destination principle is also expected to apply in the ordinary way to cross-border supplies of services over the Internet. An issue arises as to whether particular services supplied over the Internet have been exported, but this issue arises generally with the export of services. Similarly, the taxation of services provided over the Internet by foreign suppliers depends on the general tax treatment of imported services. Because of the difficulties in identifying the provision of services by a foreign supplier, some countries do not tax the supply of such services. More commonly though, a reverse-charge rule applies to imported services so that the person using the services is liable for the consumption tax on the supply of the services. However, this is usually confined to exempt business-users (such as financial institutions). Whatever the existing rule, it should apply equally to services provided over the Internet. Professor Krever observed that the existing rules in consumption tax laws create a bias in favor of consumers acquiring services from foreign suppliers (rather than domestic suppliers). The Internet makes the acquisition of services from foreign suppliers much easier, thereby exacerbating this bias.

25. He observed that the supply of digital products over the Internet raises the most significant issues in the application of consumption taxes. This is relevant for any product involving sound, data or visual graphics that can be captured in digital form and delivered over the Internet, such as music, books, software, video and film recordings. He identified two difficulties with such transactions. The first difficulty is identifying whether a supply is a domestic supply or an export. Any customer can use a domain-free Internet address that makes it impossible for the seller to know where the customer is located. As a means of verifying credit card payment for online orders, customers are often required to provide the billing address for the credit card. Professor Krever suggested that this could be used to determine whether the supply is a domestic supply or export. The second difficulty is in the taxation of imports, as they do not pass through customs or postal authorities, as in the case of an ordinary supply of tangible goods. He queried how serious this issue was because of the limited number of products that can be supplied in digital form. The main options for dealing with this case are discussed in his paper, including the "bit" tax and surrogate taxation of financial transactions used to pay foreign suppliers. It was concluded that an acceptable solution is yet to be found, although the European Community, in particular, is continuing to work on the issue.

26. For income tax, Professor Krever argued that e-commerce does not raise any genuinely new issues. Instead, the issues relate to the application of traditional international income tax principles to e-commerce transactions. The debate has focused particularly on the source of income and the meaning of 'permanent establishment'. Professor Krever argued that the multi-dimensional nature of e-commerce transactions simply raises the same source issues as conventional transactions where several parties in different countries are involved. This is illustrated in his paper by examples.

27. Under tax treaties, a contracting state is only permitted to tax the business profits of an enterprise of the other contracting state if that enterprise has a permanent establishment in the first-mentioned state and the profits are attributable to the permanent establishment. The issue identified by Professor Krever is at what point does an electronic presence constitute a permanent establishment? Professor Krever argued that a leased computer server or leased space on a computer server might constitute a permanent establishment, particularly where it took orders and accepted payment details. However, a web page on a server that merely advertises products might be excluded from the definition of permanent establishment if it uses the facilities solely for the display of goods. Similarly, a server holding a computer program for uploading products might be excluded as a facility for the maintenance of stocks of goods. Professor Krever noted that, even if a server can constitute a permanent establishment, then this is avoided by using a server located outside the jurisdiction.

28. He highlighted some important observations on tax administration aspects of e-commerce. In particular, he observed that the impossibility of sending cash through the Internet means that a third party (such as a financial institution or credit card company) is likely to have a record of the transaction that would not exist in a conventional cash sale.

Impact of Globalization on Reform of International Tax Rules

29. **Professor Lee Burns** spoke on international tax issues arising from globalization from the point of view of a tax lawyer. He observed that, while there is broad agreement on the basic principles of international tax, there are differences from country to country in the legal implementation of these principles. These differences can give rise to gaps and overlaps. He gave examples of such differences in relation to the definition of a resident, income characterization and source rules.

30. Importantly, he observed that compatibility issues are not confined to the basic principles of international tax. Today, virtually every substantive provision of income tax has a potential international application. Thus, differences in any aspect of the design of the income tax can give rise to conflicts. In his presentation, Professor Burns illustrated this by reference to two areas of current interest, namely, taxation of partnership income and taxation of expatriate labor (particularly, fringe benefits and retirement savings).

31. He observed that national sovereignty has been a key feature in the design of income taxes. While substantial commonality exists in the design of other taxes, such as VAT and customs duties, this is not the case with income tax. The issue then is how does one make income tax laws fit together? Professor Burns observed that the traditional mechanism for achieving compatibility is through a tax treaty. Tax treaties are essentially agreements between two countries setting out the basic taxing rights with respect to income flowing between two countries. The primary relevance of a tax treaty is in setting out the extent of a country's taxing rights as a source country. In particular, a tax treaty may exclude or limit a source country's right to tax. Thus, the basic approach involves the interposition of a tax treaty between the national income tax laws of the two countries as the means of coordinating those laws.

32. Clearly, a double taxation agreement (DTA) can bring about greater compatibility of income tax laws and Professor Burns cited examples of this. However, he raised many problems with the current use of tax treaties. First, many international transactions are genuinely global involving several countries, whereas tax treaties, to date, are bilateral in nature. For example, as currently drafted, there are difficulties in applying tax treaties in so-called "triangular cases". Secondly, tax treaties are having a negative impact in the way countries design their income tax laws, because of the belief that they must have something to negotiate. Thus, differences in tax treatment may arise depending on whether the foreign investor is a resident of a treaty or non-treaty country. In the global economy, such differences do not seem to make any sense. Thirdly, such differences may be difficult to sustain because

of the prevalence of treaty or forum shopping. In the absence of an anti-treaty shopping rule, it is not particularly difficult for a foreign investor to take advantage of the treaty with the lowest rates regardless of where the foreign investor is resident. Finally, tax treaties are simply not detailed enough to deal with the many complex coordination issues that arise.

33. Professor Burns considered some alternatives to current tax treaties as a means of achieving greater coordination. The first alternative is to negotiate more detailed tax treaties. Rather than simply signing off on the OECD Model Treaty, negotiators could agree on a more detailed treaty that better coordinates the two laws. Given past experiences, he concluded that this is unlikely to occur. The OECD has, in the past, encouraged countries to deal with particular issues (such as taxation of partnership income) in their bilateral negotiations, but this has rarely occurred. It could undertake to institutionally develop more detailed tax treaties. Indeed, in many ways, this is what happens with their on-going work. The difficulty is in implementing the changes. Any amendment to the OECD Model Treaty will be of prospective operation only as it is not feasible to renegotiate every existing tax treaty. For this reason, the OECD has amended the Commentary to the OECD Model Treaty, in the hope that the changes will be seen as clarifications in the interpretation of existing treaties. This technique is somewhat problematic though.

34. The second alternative is the negotiation of a multilateral tax treaty. The problem here, as with any treaty (tax or otherwise), is that the more parties required for agreement, the less (not more) detailed the agreement will be. This is the same problem faced by tax harmonization (i.e., agreeing on a common design for income tax). There will simply not be agreement on a single solution.

35. The third alternative, favored by Professor Burns, is the development of model income-tax laws. This approach recognizes that, because of sovereignty, there will be different approaches adopted by countries to the design of the income tax. So, instead of insisting on a single approach, the development of model income tax laws would allow countries to design the income tax as they chose, but in doing so they are made aware of the compatibility issues that arise with the design choices they make. The model would not involve a single prescriptive solution to each design issue; rather it would identify the design options and indicate the compatibility issues that may arise for each option. This means that there is at least awareness of the compatibility issues in income tax design.

36. Professor Burns also discussed the topic of tax incentives to encourage foreign direct investment. It is for economists to determine the economic benefits (if any) of tax incentives (such as tax holidays). From the perspective of a tax lawyer, tax incentives offer opportunities for tax planning. Because of tax planning, the revenue foregone from tax incentives may be much greater than estimated. He also discussed tax competition in relation to highly mobile capital investment.

Conflicts of Jurisdiction to Tax

37. **Profs. Krever and Burns** gave a presentation on their paper on **Jurisdiction to Tax International Transactions: Identifying the Source of Income**. The presentation further developed issues relating to jurisdiction of tax raised in Professor Mizuno's paper. The authors argued that there are few limitations as a matter of public international law (i.e., the law among nations) on a nation's jurisdiction to tax. In fact, it is likely that a nation's jurisdiction to tax will be defined more by practical considerations, particularly the general rule of private international law that a nation does not have to recognize the tax law of another nation. This means that, in the absence of an international agreement, the tax administration of one country cannot enforce its tax laws in another country. In particular, it cannot use the debt recovery process in another country to recover tax due. This means that the assertion of jurisdiction to tax (particularly in relation to non-residents) must be one that can be enforced.

38. A nation's assertion of its jurisdiction to tax may be based on personal or economic attachment to a territory. The personal attachment with a territory refers to the relationship between the subject of taxation and the territory. This is normally defined by the concept of residence. Taxes imposed on the basis of personal ties tend to be global income taxes, imposed on all incomes from all sources. The economic attachment with a territory refers to the relationship between the income and the territory. This is normally defined by reference to the source of income. Taxes imposed on the basis of economic attachment tend to be schedular in nature, with different rules applying to different types of income.

39. Many countries use both attachments to define their jurisdiction to tax. In this case, residents are taxed on worldwide income (personal attachment) and non-residents are taxed on domestic source income only (economic attachment). However, some countries tax only on the basis of economic attachment. This is referred to as the territorial basis of taxation.

40. In their paper, the authors concentrate on issues relating to economic attachment as the basis for taxation, particularly the source of income. This is mainly relevant to the taxation of non-residents, although, in the case of territorial tax systems, it is relevant to the taxation of all persons. Because taxation on the basis of economic attachment is schedular in nature, the first step is to characterize the income as different rules apply to different types of income. Once the income is characterized, it determines what source rule applies, namely, the basis of tax (net or gross) and the rate of tax.

41. The authors stated that, while source is accepted as a basis of taxation, there is no universally accepted set of rules for determining the source of income. Indeed, some countries may have only a broad formulation of source in their tax law relying on a case-by-case approach, particularly through judicial decisions. The authors pointed out that there is a trend toward the inclusion of a detailed set of rules relating to source

in tax laws. This has the major advantage of certainty in the application of source jurisdiction, although it recognized that such an approach may be open to some manipulation by taxpayers and may be less flexible to deal with new business transactions or methods.

42. The authors also stated that in developing statutory source rules, the trend is to use the rules commonly found in tax treaties as their basis. This limits the possibility of conflicts in the application of source rules and achieves neutral treatment of persons resident in treaty and non-treaty countries. There has been some fine-tuning of treaty source rules to take into account the political compromises that a treaty may involve.

43. The authors discuss source rules commonly used for particular classes of income, such as the sale of goods, provision of services, dividends, interest, royalties, rental income and capital gains. The authors highlighted the conflicts that can arise when countries adopt different source rules for the same type of income. This can give rise to dual source problems, which may not necessarily be overcome by tax treaties. The authors also stated that conflicts could arise when countries adopt different views as to the character of the income, thereby resulting in the application of different source rules. Again, tax treaties do not always resolve these conflicts.

44. **Dr. Satoshi Watanabe, an Associate Professor from the Institute of Economic Research, Hitosubashi University, Japan** gave a presentation on **International Taxation: The Experience of Japan**. In his presentation, he spoke on two key issues of international tax: tax competition and electronic commerce. He discussed the work of the OECD on harmful tax competition. Importantly, he said that discussion of tax competition should not be confined to "harmful" cases. He emphasized that the "more general nature of tax competition, namely a conflict between border-less economic activities and tax systems under jurisdiction of each country," should also be kept in mind. While recognizing that tax competition may be beneficial in rationalizing tax systems, Professor Watanabe observed that tax competition makes it more difficult for each country to choose its tax policies without taking into account the reactions of other countries. Professor Watanabe concluded that the discussion of tax competition in the local public finance literature of the 1970s might provide some solutions to tax competition in the international context.

45. He also discussed the work of the OECD in the area of e-commerce. He focused particularly on the implications for consumption taxes and concluded that the current VAT system cannot capture cross-border transactions of services, intangible goods and digitalized goods, particularly where the supply is by e-commerce. He noted that there is ongoing work on the taxation issues raised by e-commerce.

46. Professor Watanabe also discussed tax administration issues, again particularly in relation to e-commerce. While international coordination of tax systems may be difficult, even impossible, he stated that administrative cooperation is a more realistic objective. He emphasized the importance of the exchange of information among tax administrators to deal with e-commerce transactions and innovative financial instruments. Finally, he observed that e-commerce technologies might be used by tax administrators for collecting and processing information (including returns), and in the collection of taxes. He has included a summary of the 1999 tax reforms in Japan in an appendix to his paper.

47. **Mr. Abdullah Jihad, Deputy Director, Department of Inland Revenue, Republic of Maldives and Mr. Vidyadhar Mallik, Director-General, Department of Taxation, Nepal, spoke on Tax Reforms in Developing Asia.** Both Mr. Jihad and Mr. Mallik presented papers on tax reform in their own countries as case studies on tax reform generally in developing Asia. Importantly, the nature of the tax reform undertaken by the two countries is different. In the case of the Maldives, tax reform involves the introduction of the country's first broad-based income tax, while, in the case of Nepal, tax reform involves modernizing the existing income tax. Consequently, the case studies provide interesting contrasts in tax reforms.

48. Mr. Jihad stated that previously the collection of taxes, fees and charges in the Maldives was fragmented across several different ministries. This meant that different collection and enforcement procedures applied to these different imposts thereby resulting in unnecessary overlapping and duplication of administrative effort. The Department of Inland Revenue was established in 1996 with a view to centralizing the tax administration effort in the Maldives. The Department has taken over the assessment and collection of nearly 30 existing taxes, fees and charges. Mr. Jihad explained the tax administration reforms that have resulted in the establishment of the Department of Inland Revenue.

49. The Department of Inland Revenue will have responsibility for the business profits tax and the property rental value tax that are likely to enter into force in the near future. A tax administration law will accompany the introduction of these taxes. He outlined the broad design of these taxes and detailed important policy issues still to be resolved. The business profits tax will be charged on every person in respect of profits of a business or profession carried on or managed from the Maldives. A lower rate will apply to a business carried on outside the Maldives. The business profits tax will not apply to investment income (unless incidental to the operations of a business), capital gains or employment income. The policy issues to be resolved include the tax-free band and tax rate structure; exemptions; loss carry-forward rules; provisional tax and the treatment of non-residents (including withholding taxes).

50. While drafts of these laws were prepared in 1996, the government has not yet implemented them. The government wanted to ensure that the design of the laws is appropriate for the Maldives and that adequate tax administration resources exist. Finally, the government is also considering the introduction of a value-added tax.

51. Mr. Mallik explained that Nepal has undertaken major tax reforms in recent years. This has involved the simplification of the income tax rate structure. In the past ten years, the number of income tax rate bands (including a zero rate) has been reduced from eight to four. Recent income tax reforms have involved broadening the income tax base (including the removal of tax holidays and taxation of fringe benefits) and lowering the rates. A presumptive tax system has been introduced based on the so-called "six eternal signs of a potential taxpayer", namely, size of home; amount of telephone bill; foreign travel; membership of certain clubs; car ownership and possession of a credit card. An important current project is the consolidation and modernization of the income tax law.

52. He added that particular emphasis had been placed on international tax issues. Nepal has been very active in tax treaty negotiations and is closely monitoring e-commerce taxation issues. Allocation of deduction rules has been adopted for Nepalese branches of foreign companies to limit transfer-pricing abuses. Nepal has been active in seeking regional solutions to international tax issues, particularly the harmonization of tax treaty policies in the region to avoid tax competition. It has also agreed to participate in regional mutual cooperation in administration, including the joint audit of taxpayers.

53. There have also been important changes in tax administration. Greater reliance has been placed on withholding taxes, with nearly 70 per cent of income tax collected by withholding at source. Self-assessment has been introduced. This has been accompanied by a system of advanced rulings. A current payments system has also been introduced. Generally, a much greater emphasis is now placed on service to taxpayers, including taxpayer education. Important current administration projects involve computerization and human resource development (including a non-monetary incentives system for tax officials).

54. As regards other taxes, Mr. Mallik advised that Nepal has recently introduced VAT. It is imposed at a single rate of 10 per cent on the destination principle. Exemptions have been kept to a minimum. The successful implementation of VAT is a key objective of the current financial year. Other tax reforms include the simplification of the customs tariff and the introduction of the GATT valuation system based on real transaction value for customs purposes.

Country Reports on Selected Issues by Respective Country Delegates

55. During the Seminar, country reports were presented for: People's Republic of China (PRC); Hong Kong, China; Indonesia; Korea; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. It was clear from these reports that countries in the region were facing a number of tax issues, particularly those relating to international taxation. The main issues and policy measures that emerged in the country paper presentation and during subsequent discussions are summarized below.

56. ***Electronic commerce:*** Most country reports cited the impact of e-commerce on income tax and VAT as an important issue under review. It was recognized that a lot of work is being done in the area of e-commerce in countries outside the region and by the OECD. Countries in the region are closely monitoring this work as they formulate their responses to the issue. It was generally acknowledged that international cooperation will be important in determining solutions to the issues raised by e-commerce.

57. ***Transfer pricing:*** Several countries reported that transfer pricing continues to be an issue under review. The country report of Hong Kong, China set out examples of transfer pricing abuses that the administration had come across, including the allocation of income and expenses between Hong Kong branch and foreign head office. It was stated in the report that the law provides for a formulary approach, where the branch's accounts do not disclose the true profits derived in Hong Kong, China. Philippines has developed administrative rules for audit of multinational enterprises, including the use of the OECD guidelines on transfer pricing in determining an arm's-length price. Thailand also reported that, in practice, the OECD guidelines are followed. Singapore is examining transfer-pricing issues, particularly the determination of a fair market price where comparative pricing is not available. In Taipei,China, the tax administration must apply to the Ministry of Finance before adjusting a taxpayer's income under transfer pricing rules.

58. ***Financial crisis:*** Several countries detailed measures taken in response to the financial crisis in the region. PRC has increased export incentives and provides tax credits for investments in certain approved projects. Hong Kong, China has exempted any interest on deposits placed locally with financial institutions from its profit tax. This is intended to encourage residents to repatriate offshore deposits to Hong Kong, China to improve the liquidity and lending ability of local banks. Further, to increase corporate liquidity and encourage consumer spending, a tax rebate equal to 10 per cent of the final tax liability for 1997-98 was given to all taxpayers. Korea has introduced a number of measures to facilitate corporate and financial restructuring, including exemption from, or deferral of, capital gains tax, acquisition tax and registration tax. Further, tax incentives have been provided to small and medium-sized enterprises to stimulate employment and technology investment. Finally, tax relief measures have been adopted for low and middle-class earners. Malaysia will move from a preceding-year to a current-year basis of assessment for income tax commencing in 2000. This is aimed at ensuring that the revenue collection of the government reflects the current performance of the economy. In implementing this change, the government has waived all income derived in 1999 from income tax whilst losses in that year will be allowed to be carried forward. Other measures include an exemption for foreign income remitted to Malaysia by 31 December 1998 and incentives to encourage home ownership.

59. Philippines has a package of reforms relating to the financial sector currently before Congress. The package includes

measures to ensure a more equal treatment of offshore banking units and domestic banking units. Singapore has adopted a number of tax measures to stimulate growth, including income tax rebates for individuals and companies, refining the existing incentives to promote certain financial activities, and property tax rebate for commercial and industrial properties. These also encompass property tax exemption for land under development, suspension of stamp duty on contract notes for share transactions and reducing the employer's contribution to the Central Provident Fund. Taipei,China has reduced the gross revenue tax on financial institutions from 5 per cent to 2 per cent. The required reserve ratios have also been reduced. The government has stipulated that banks are to use the resulting increase in earnings to write off non-performing loans over the next four years. Further, the procedures for writing off such loans have been simplified.

60. Thailand has adopted tax measures to increase disposable incomes and stimulate private consumption. These include measures to reduce the tax burden of small enterprises. Some countries have broadened their tax base in response to the crisis. PRC has restructured its turnover taxes and introduced a land appreciation tax. It also proposes to introduce an inheritance tax. In Korea, the VAT base has been expanded and more effective enforcement of the inheritance tax has been undertaken. Further, a policy of rationalizing and eliminating tax exemptions and reductions has been adopted. The government is evaluating the merits of introducing a "tax expenditure system" to better monitor the impact of tax concessions.

61. ***Other issues and reforms:*** There has been a downward trend in corporate tax rates. Malaysia has reduced its corporate rate from 30 per cent to 28 per cent. Philippines is in the middle of a staged reduction of the corporate tax rate from 35 per cent to 32 per cent. Taipei,China has reduced the corporate rate from 35 per cent to 25 per cent. It has recently introduced the imputation system of taxing companies and shareholders (based on the German model). Indonesia has introduced an anti-deferral rule. Malaysia stated that it was studying the taxation of income arising from innovative financial transactions.

62. ***Tax incentives:*** Different approaches were reported on the issue of tax incentives. PRC and Indonesia reported that targeted tax incentives were being used as a means of attracting new foreign investment. In the case of Indonesia, this was seen as an important measure to reduce reliance on revenue from the oil and gas sector. Korea reported that tax holidays were used to encourage advanced technology investment by foreign businesses. Also Korea has removed restrictions on real estate acquisition by foreign investors. Malaysia reported that a wide range of tax incentives is offered to encourage foreign investment, including tax holidays, investment allowances and double deductions. Singapore and Taipei,China also reported extensive use of tax incentives to encourage foreign investment. Philippines reported that, in the past, a wide range of tax incentives has been offered in respect of a diverse range of economic activities. It has been concluded that many of these incentives have been useless and inefficient in attracting foreign investment. As a result, a policy of rationalizing fiscal incentives has been undertaken. Under the new regime, tax incentives will only be granted for industries with high comparative advantage and to exporters.

63. ***Tax administration:*** Most countries reported that tax administrations were making greater use of information technology. Electronic filing and payment is in place in Hong Kong, China, Singapore and Taipei,China. Philippines reported that it is examining the filing and payment of tax by electronic means. Changes in organizational structure of the administration were reported in Korea (the tax division approach has been changed to a functional approach). The administration of direct taxes in Malaysia has been entrusted to the Inland Revenue Board, a corporate body established under an act of parliament. Several countries reported on the introduction of self-assessment. In the case of Korea, it was reported that the full benefits of self-assessment had not yet been realized with processing returns continuing to be a major component of the administration's activity. The reasons for this have been identified and a strategy has been put in place to better utilize administrative resources (including the better design of forms). Malaysia reported that self-assessment will be implemented in stages commencing in 2001 for companies.

Conclusion

64. **Professors Krever and Burns and Dr. Adhikari** summed up the key messages that arose in the seminar. First, the relationship between globalization and coordination in international taxation is very important. It is essential to ensure that income is taxed, but taxed only once. Thus, it is necessary to avoid gaps and overlaps in the coordination of the income tax laws as they apply to international transactions. Second, it is now more important than ever for countries to be aware of the application of their domestic tax laws to international transactions and also the income tax laws of their major trading partners. Third, it is clear from the country presentations by the delegates that much greater attention is now being paid to international transactions (e.g., e-commerce, transfer price and thin capitalisation). Fourth, while the traditional coordination mechanism is the double tax treaty, an issue for the future is whether the tax treaty is still the best way to coordinate tax laws or if there should be a special arrangement — multilateral or regional — for tax policy harmonization and tax administration coordination. Finally, globalization highlights the importance of cooperation. Cooperation between nations is one way to reverse tax competition, or, at least limit its impact. But cooperation needs to be broad based, otherwise tax competition will continue. Cooperation between administrations is also vital. This might encourage further thinking towards the desirability of greater global arrangements for taxation.

BONUS

Abstract from the New Working Paper on "Development of the Financial System in Post-Crisis Asia" by John Williamson

The evidence of the East Asian crisis is now in, and does indeed point to the conclusion that weaknesses in the financial systems and free capital mobility played a central role in propagating and deepening the crisis. All the crisis countries had essentially opened themselves to uncontrolled inflows of short-term funds, and allowed foreign borrowing of their domestic currency. It is well known that the abolition of capital controls has often been followed by a large inflow of capital. Moreover, this inflow has typically been disproportionately in the form of short-term capital. As the crisis developed, domestic financial institutions found themselves unable to borrow, or even to roll over maturing loans on any terms at all.

A major factor behind the financial crisis was the unbalanced currency exposure resulting from a large level of dollar borrowing. As illustrated by the case of Thailand, this meant that depreciation of the baht produced illiquidity/insolvency of the banks either directly (if the currency exposure was taken by them) or indirectly (if the currency exposure was taken by their customers, whose loans then turned bad). The banks' financial problems then forced them to cut back lending, which aggravated, and may have been the principal cause, of the recession that followed.

In terms of recommendations, the author suggested that while current account convertibility is certainly desirable, countries that still have capital controls should not be expected to make a sudden rush for convertibility. Such controls may be aimed at controlling the sudden withdrawal of short-term loans, by banks and other financial institutions, which led to earlier crises.

While the author expressed a belief that people and governments can learn from the experience accrued from the financial crisis, he was actually less optimistic as to whether market participants will learn things that will head-off future crises. He also expressed doubts as to whether personal incentive structures in markets are calibrated in a way that makes it individually advantageous to take actions that reduce the likelihood of crisis. This will change only when governments decide to do something to change the parameters within which the markets operate.

The primary lesson that the author drew for crisis-affected countries is to be cautious about liberalizing the capital account. This does not mean that they should freeze all activity in that direction, but it does mean avoiding getting carried away by euphoria when growth trends return, as now appears to be the case.

A second lesson was that even if bankruptcy laws, good supervision, reformed corporate governance are of marginal relevance to the avoidance of crises, they are important to prepare developing countries for the next stage of development. In East Asia, the main needs are for strengthened bank supervision, better bank management, and, once that is in place, bank recapitalization. The final step would be to reprivatize those banks that were saved by the injection of public funds and are now owned by the government. He also mentioned that despite images to the contrary, equity markets are already rather well developed in Asia in comparison to world norms.

In terms of banking reform, Dr. Williamson suggested an orderly approach that starts with building up supervisory and managerial capacity, followed by raising interest rates to something close to market-clearing levels. Only then should interest rates be freed and all controls on the flow of credit be abolished. As already argued, capital account liberalization should be left to the end.

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