

TAXATION
OF
FOREIGN AND NATIONAL ENTERPRISES

**A STUDY OF THE TAX SYSTEMS AND THE
METHODS OF ALLOCATION OF THE PROFITS
OF ENTERPRISES OPERATING IN MORE THAN
ONE COUNTRY**

IN

**FRANCE, GERMANY, SPAIN, THE UNITED KINGDOM
AND THE UNITED STATES OF AMERICA**

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PREFACE.

One of the most difficult problems involved in the prevention of double taxation is that of allocating or apportioning the income of enterprises between the various countries in which they do business.

The League of Nations, which undertook to co-ordinate efforts with a view to the abolition or attenuation of double taxation, convened several Committees and Conferences with this object, the last of which—the General Meeting of Government Experts on Double Taxation and Fiscal Evasion—met at Geneva in 1928 and framed three model bilateral Conventions for the avoidance of double taxation. These three types of convention all deal with the taxation of industrial and commercial enterprises, and lay down, in substance, the principle that these enterprises are taxable only in the country where they have a permanent establishment; where the same enterprise has establishments in each of the two contracting States, the income should be allocated or apportioned between them in accordance with rules to be agreed upon by the competent authorities.

Double taxation is to be prevented, according to one Convention, by the country in which the enterprise is domiciled exempting from taxation income derived by the establishment in the State of origin, or, according to the others, by the said country granting a certain deduction from its tax in respect of the tax payable in the country of origin.

These provisions are not sufficient in themselves to prevent double taxation, because the law and practice of the various countries differ in regard to determining the amount of the profit that should be allocated to establishments within their respective territories. Consequently, assessments may overlap and the same profits be taxed in two or more countries.

The Conference of Government Experts saw the difficulty, but did not consider itself to be in a position to solve it. It merely suggested that the fiscal administrations should come to some understanding with a view to fixing rules for apportionment. The Fiscal Committee—a new permanent body set up by the Council of the League of Nations—was therefore instructed to seek a general solution of the question.

At its first meeting in October 1929, a preliminary questionnaire was drafted and sent out to the Governments of important commercial countries. The International Chamber of Commerce was invited to co-operate in securing the views of business enterprises. The information elicited by this first questionnaire, which was considered by the Fiscal Committee at its second meeting held in May 1930, revealed in a general way the great diversity in the law and practice of the various administrations, as well as the complexities of the various problems of allocation. It was evident that a more detailed and thorough study would have to be made before attempting to draft uniform rules of allocation.

This study was made possible by a grant of \$90,000 from the Rockefeller Foundation, secured primarily through the efforts of Dr. Thomas S. Adams, the American member of the Fiscal Committee. The responsibility of the enquiry was entrusted to a Sub-Committee, composed of its President, M. Marcel BORDUGE, Councillor of State, Director-General of Income, Registration and Stamp Taxes in France; M. BLAU, Director-General of Taxes in Switzerland; Dr. Herbert DORN, President of the Supreme Court of Taxation in Germany; Professor FLORES DE LEMUS, Adviser to the Spanish Ministry of Finance; and Sir Percy THOMPSON, Deputy-Chairman of the United Kingdom Board of Inland Revenue. This Sub-Committee appointed Mr. Mitchell B. CARROLL, former Special Attorney in the United States Treasury Department, to direct the enquiry.

The first stage of the enquiry was restricted to five countries, and a study of their income-tax laws and administrative practice forms the subject of the present volume. Each of the reports contained therein is the result of Mr. Carroll's collaboration with the national members of the Fiscal Committee, and with the following experts :

For France : M. Jean GUILLET, Sous-chef, Direction générale de l'Enregistrement, Ministère des Finances and M. Roger PIERRE, Sous-chef, Direction générale des Contributions directes, Ministère des Finances ;

For Germany : Herr Werner PAASCHE, Ministerial Councillor, Ministry of Finance ;

For Great Britain : Mr. E. W. VERITY, Principal, Board of Inland Revenue ;

For Spain : Professor Agustín VINALES, Professor of Political Economy and Finance, University of Granada ;

For the United States : Mr. Joseph WEARE, Audit Review Division, and Miss M. L. McMORRIS, Rules and Regulations Section of the Bureau of Internal Revenue, United States Treasury Department.

The reports comprise, first, a general description of the income-tax system, and, secondly, a detailed description of the methods of taxing the principal classes of income subject to direct taxation, from the point of view of foreign and national enterprises. The third part deals with the various aspects of the problem of apportionment.

In order to facilitate a comparison between the methods of apportionment employed in the different countries, Mr. Carroll has made a general survey, which serves as an introduction to the present publication.

In framing the reports, Mr. Carroll has kept closely in touch with the National Committees of the International Chamber of Commerce, from which he has received documentary material which will be submitted to the Fiscal Committee.

The Fiscal Committee, at its meeting in May 1931, took cognisance of the first results of the enquiry, It was decided that it should be continued on the same lines in other European and extra-European countries, and their tax laws and administrative practices in regard to apportionment will be described in a later publication.

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**GENERAL SURVEY OF THE ALLOCATION METHODS
EMPLOYED IN FRANCE, GERMANY, SPAIN, THE
UNITED KINGDOM, AND THE UNITED STATES OF AMERICA**

BY

MITCHELL B. CARROLL,

LL.B., Lic. Droit (Paris), D. Jur. (Bonn),

Former Special Attorney, United States Treasury Department,

Director of the Enquiry on Allocation Methods.

I. GENERAL SUMMARY.

The enquiry into the existing law and practice of France, Germany, Great Britain, Spain and the United States of America in regard to allocation or apportionment of the taxable profits of enterprises to sources within or without those countries reveals a wide range of different methods, but also a great similarity in the principal methods employed by the majority of countries. In general, these methods will be discussed from the viewpoint of branches of foreign enterprises; but, as is indicated below, there are circumstances in which certain countries assimilate in effect a local subsidiary company to a branch.

BRANCHES OF FOREIGN ENTERPRISES.

The normal procedure in Germany, Great Britain and the United States is to tax a branch of a foreign enterprise on the basis of its own accounts, provided they are satisfactory or can be properly adjusted.

In France, this method is employed for the purposes of the tax on industrial and commercial profits (*impôt sur les bénéfices industriels et commerciaux*), but the tax on income from securities (*impôt sur le revenu des valeurs mobilières*) is payable by a foreign company with a branch in France on the basis of the same proportion (*quotité imposable*) of the dividends and interest paid by the foreign company as its assets in France bear to its total assets.

In Spain, the normal procedure is to allocate to the branch in Spain a percentage of the entire profits of the foreign enterprise.

Where separate accounts are not kept, or when they are improperly kept, or where they are properly kept but do not reflect the true income of the branch or subsidiary company, the general practice in France for the commercial profits tax, and in Germany, Great Britain and the United States of America, is to have recourse to a comparison with similar enterprises, frequently taking into account, in the case of industrial and mercantile enterprises, the percentage of net profits to gross turnover. This percentage may be taken as a basis for taxation in France, Germany and Great Britain, but in the United States it is ordinarily used merely as a lever to prevail upon the taxpayer to correct his accounts so as to reveal the true income. In Germany, the amount thus assessed must not be less than the normal rate of interest on the capital employed in the local branch.

Other empirical methods include: (1) assessment on the basis of an agreed amount, sometimes resulting from an estimate of income, sometimes from applying an agreed percentage to turnover, and usually employed over a period of from three to five years (Germany and Great Britain); (2) assessment on the basis of the normal rate of interest on the capital invested in the branch (Germany); (3) apportionment of total income in accordance with the ratio of turnover, of assets, or with a combination of both elements as is provided in the regulations of the United States Income Tax Act (Regulations 74, Article 682).

The usual reason for disregarding the results of the separate accounts and resorting to some empirical method is that the accounts show little or no profit. Not infrequently, this results from the enterprise invoicing goods to the branch at so high a price as to restrict the profit realised by the branch when the goods are sold, or to excessive charges made for interest,

services, royalties, or on some other account. In view of the difficulties of ascertaining what is an appropriate invoice price, the tendency on the part of tax officials is not to try to ascertain a fair price but to turn at once to a comparison of the percentage of net profit to gross turnover of similar businesses, or to employ some other empirical method.

The feeling prevails in some countries that it is impossible to keep accurate separate accounts for some businesses, and therefore an empirical method is the only kind that can be employed.

SUBSIDIARIES OF FOREIGN COMPANIES.

The question of taxing subsidiary companies is of special interest, because of the various methods that are employed to reach the foreign parent when the tax authorities feel that, through inter-company transactions, the profits of the subsidiary have been improperly restricted. The commercial law of each of the five countries considers a company organised under its laws as a legal entity with a personality distinct from that of its members and possessing property distinct from that of its members. Nevertheless, this separate personality can be disregarded, and a subsidiary company can be treated as a branch of the foreign parent under specific provisions in the laws of Germany and Spain, and in effect under the practice of the French tax administration in connection with the tax on income from securities, which practice has been upheld by various decisions of lower tribunals.

This merging of the subsidiary with the parent may take place under German law when the two form an economic unit, and under Spanish law when the Spanish company is in one of the four situations specified in the law and described below (see pages 37 and 38). In each case, there is a very close dependency of the Spanish company on the foreign company.

The French courts have drawn foreign corporations into the jurisdiction of France, for the purpose of imposing the tax on income from securities, when they own the majority of the registered shares and have a majority on the board of directors of a French corporation (*société anonyme*) with similar objects. The laws of Great Britain and the United States, however, have been able to circumvent the shifting of profits from the subsidiary to the parent without in any way disregarding the corporate fiction. Under the British Finance Act of 1918, this is done by treating the British subsidiary company as agent for the parent company, and taxing the latter in the name of the subsidiary on a certain percentage of its turnover. The American law provides that, where two businesses are owned or controlled by the same interests, the Commissioner of Internal Revenue is authorised, if he considers it necessary in order to prevent tax evasion or clearly to reflect income, to distribute gross income or deductions between the two businesses so as to place them in the same position as if they had been dealing at arm's length (Revenue Act of 1928, Section 45).

In all five countries a local subsidiary company must keep separate accounts, but the existence thereof, even though perfectly accurate, does not preclude the French, German and Spanish administrations from subjecting the foreign parent corporation to tax, once the requirements indicated above have been fulfilled.

PRINCIPLES CONCERNING PRODUCTION OF INCOME.

It is important to signalise certain fundamental differences in the concepts as to what gives rise to income under the various systems of law. In France, Germany and Spain, liability to tax arises when the foreign enterprise possesses a permanent establishment within the country. The tax is imposed because of commercial activities being carried on by the establishment,

sometimes without regard to whether profits have actually been derived. For example, a foreign enterprise which has an establishment within one of those countries for the purpose of buying raw materials is subject to tax, even though the materials are immediately exported and used or sold by establishments of the enterprise in other countries. Under the laws of Great Britain or the United States, however, income must really have been derived or accrued, for example, from the sale of goods or services. Consequently, a foreign enterprise can have a permanent establishment in either Great Britain or the United States without being subject to income tax because of the fact that the establishment neither manufactures nor sells goods, nor renders services to third parties for remuneration.

LEGISLATIVE PROVISIONS FOR ALLOCATION.

Another matter of interest is that only the law of the United States has provided a complete system of allocation for enterprises, whether foreign or domestic, doing business within and without its territory. Section 119 of the Revenue Act of 1928, interpreted by Article 682 of Regulations 74, specifically defines sources of income within and without the United States, and provides for the allocation of income partly from sources within and partly from sources without the United States—*e.g.*, income derived from the purchase or production of goods without and their sale within the United States. This section also provides that items of expense directly allocable to those items of gross income shall be deducted in computing the net income. The balance of expenses incurred by a foreign enterprise which cannot be directly allocated, which generally includes interest, salaries to executive officers and other items of general overhead, may also be apportioned. A rateable part of the overhead of a foreign enterprise may thus be deducted in computing taxable net income from United States sources.

There are apparently no specific provisions in any of the other four countries concerning the allocation of income or deductions, including the deduction of a proportionate part of the general overhead of a foreign firm; but fairly complete systems have been evolved in practice from the basic principles of the tax law, which for the most part correspond to the American system.

II. LAW AND PRACTICE OF EACH COUNTRY WITH REGARD TO FOREIGN ENTERPRISES.

I. METHOD OF SEPARATE ACCOUNTING.

As previously indicated, the normal procedure in France for the purposes of the tax on industrial and commercial profits, and in Germany, Great Britain and the United States, is to tax the local branch of the foreign enterprise on the basis of its declaration, supported by its accounts. If they are unsatisfactory, the fiscal authorities attempt to adjust them if possible, or resort to the use of some empirical method of assessment.

(a) *Accounting Requirements.*

In the tax laws of the countries which rely primarily upon the method of separate accounting, there are no specific provisions as to the form of the accounts. In the American law, for example, there is only a general provision that the net income is computed on the basis of the

taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayers. If no method of accounting has been regularly employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner of Internal Revenue does clearly reflect the income (Revenue Act of 1928, Section 41). The British Income Tax Act presupposes the keeping of accounts, but contains no specific provisions. Inasmuch as accounting has been developed to such a high point in Great Britain by chartered or incorporated accountants, there is no need for special provisions in the tax law. In France, Germany and Spain, the keeping of books of accounts is required by the Commercial Code of each country, but is not the subject of any specific provisions in the Income Tax legislation of those countries.

(b) *Adjustment of Accounts.*

Where disagreement exists between the fiscal authorities and the taxpayer over certain items in the accounts, an attempt is ordinarily made to adjust them to the satisfaction of both parties concerned. Empirical methods will sometimes be employed to facilitate this adjustment, sometimes as a basis of assessment when no adjustment is possible.

Serious efforts to adjust accounts are made especially in Great Britain and the United States, in which countries the science of accounting has been highly developed. The British authorities, for example, will endeavour to ascertain the figure at which similar goods are sold by the foreign enterprise to an independent customer in the United Kingdom under conditions that are customary in the particular trade, and in other cases to determine an independent market quotation for similar goods.

If there are no sales to independent customers, or if the goods are of a special kind which has no independent market value, other lines of negotiations are resorted to. In some instances, an attempt might be made to ascertain the actual or approximate cost of the goods sold in the United Kingdom. As their sale price is known, an intermediate price for invoicing the goods might be established, making due allowance for a certain manufacturing profit which is allocable to the foreign country.

The relative percentages attributable to manufacturing and merchanting would depend on the particular business and processes, but in some instances it would be possible to determine this by a comparison with similar enterprises. As a general rule, where the British authorities and the taxpayer disagree, the authorities make an attempt to "hammer out a compromise", and this is frequently successful. The taxpayer usually prefers to come to an agreement rather than to be assessed on a percentage of his turnover. If no agreement can be reached, the tax authorities may make an assessment on an estimated amount of profit, and the onus would then be on the taxpayer to prove that this assessment was excessive.

Similarly, in the United States, the authorities attempt to determine, in the case of foreign manufacturing and mercantile enterprises, what is the sales profit realised in the United States over the price at which the foreign manufacturing plant would sell to an independent purchaser (independent factory price). This sometimes necessitates adjustment in the invoice price. Sometimes the tax officials make an analysis of the world business of the taxpayer in order to bring out facts relating to operations within the United States which will permit an adjustment of accounts on a reasonable basis.

2. EMPIRICAL METHODS.

The empirical method which is most frequently employed is that of taxing the branch of a foreign company on the average percentage of net profits to gross turnover realised by similar enterprises. Its use, however, is practically limited to industrial and mercantile enterprises.

(a) *Percentage-of-Turnover Method.*

The French administration sometimes computes the profit of a local branch or subsidiary of a foreign company by multiplying the amount of its turnover by the coefficient of the gross profit (*bénéfice brut*) determined by reference to similar French enterprises, and deducting from the amount thus obtained the general expenses of the French establishment. When the French establishment is a branch, the administration, in principle, allows a deduction, from the gross income thus evaluated, of the fraction of the general overhead of the seat of management of the foreign enterprise which is allocable to such establishment. The amount of overhead to be deducted may be determined on the basis of the proportion of turnover of the establishment to the total turnover of the foreign enterprise.

This method of allocation of general expenses does not apply, however, where the expenses may be directly allocated, as, for example, where the foreign enterprise shows in its accounts the expenses of a special service rendered to the French branch.

A variation of the turnover method used by the French administration is to calculate the net profit on a single article (*e.g.*, typewriters) made by a similar French enterprise, by the number of articles sold by the branch of the foreign company. In Germany, the percentage of turnover method is subject to the condition that the amount of income thus computed must at least equal the normal rate of interest on the capital employed in the German branch, the term capital including fixed assets, current assets, inventories and supplies.

In Great Britain, if the local establishment is an important branch of the foreign enterprise, an attempt is usually made to ascertain the percentage of net profit to total turnover of the entire enterprise. If the British establishment is engaged in activities similar to those of the foreign enterprise, such as both manufacturing and selling a particular product, the percentage ascertained for the entire enterprise is applied to the United Kingdom turnover. If the British establishment, however, merely sells the product manufactured abroad by the foreign enterprise, the percentage is normally less than that ascertained for the entire undertaking, in order to subject to tax in the United Kingdom only the "merchandising" or sales profit, and thereby allow to the country of manufacture a manufacturing profit (Income Tax Act of 1918, General Rule 12).

The United States tax administration has a table of average percentages of net income to gross receipts of various kinds of business, and frequently uses this as a basis for forcing a correction of the accounts and tax returns of the foreign enterprise rather than as a basis of assessment.

(b) *Conventional Method.*

The British and German tax administrations sometimes tax on the basis of an agreement with the taxpayer, especially in cases where the business is of such a nature that the taxable profit cannot readily be revealed by a separate accounting. Such an agreement usually provides for payment of the annual tax on an estimated profit, or on a certain percentage of its turnover, and it frequently remains effective for a period of from three to five years, at the end of which time the amount may be revised.

In Germany, this method is sometimes resorted to when a foreign firm begins operations in that country and wishes to know in advance the amount of tax payable so as to compute its operating costs. Consequently, the firm may be subject to income tax, even if no profit is realised.

3. METHODS OF FRACTIONAL APPORTIONMENT.

The one country in question which regularly employs the method of fractional apportionment for determining the taxable profits of the local branch or subsidiary of a foreign enterprise is Spain. France may use it when the method of separate accounting fails in imposing the

profits tax, and employs it regularly for determining the proportion (*quotité imposable*) of the dividends distributed or interest paid by a foreign corporation which is to be subject to the tax on income from securities. This proportion is the ratio of assets in France to total assets, and the term "asset" is broad enough to cover all kinds of real or personal property as well as business activity.

The German administration, also, may compute the income subject to its tax as a fraction of the total net profit of the foreign enterprise, on the basis of factors essential to the production of such income. The German authorities may employ this method even in the case of a foreign corporation with a German subsidiary company when the two are considered to form an economic unit. This method is used rarely in Great Britain and in the United States, and then only in cases where the foreign enterprise has a branch in the country.

(a) *Spanish System of Fractional Apportionment.*

As the method of fractional apportionment is the normal procedure for taxing foreign enterprises operating in Spain, the Spanish system will be first discussed. Until 1920, the Spanish branches of foreign companies were, in general, taxed on the basis of the income shown by their accounts. As many branches showed little or no profit, the Spanish Government was forced to develop another system that would subject foreign enterprises to a tax burden equivalent to that imposed on Spanish enterprises. The Spanish report states that the guiding principle in the reform was the establishment of a system which would meet the "100 per cent test"—*i.e.*, which would not result in subjecting to tax in all countries more than 100 per cent of the profits of the entire enterprise. Moreover, the basic principle of the Spanish law is that the tax is to be imposed on the real profit; if, therefore, each branch of an enterprise is taxed as an independent unit, the result may be that a branch will be taxed whereas the entire enterprise realises a loss, and consequently the enterprise will be taxed on more than its real profit.

The Spanish report states that, during three years, a study was made of Spanish companies which revealed that the taxation of each branch as a separate establishment would result in a tax 16 per cent greater than that which would be obtained if the enterprise were taxed as a unit. The Spanish report observes that accounts will not show the income of a branch unless they are arranged for that purpose; but the majority of foreign enterprises established in Spain maintain their accounts for other purposes, in general legitimate, but which are not of a nature to show results satisfactory to the Spanish tax administration.

It was felt that, if one maintained the basis of taxing according to accounts, it would be necessary to interfere with the liberty of enterprises. The most difficult point was the control of the prices charged by the parent enterprise to branches or subsidiaries. Except for certain articles which have a broad market, these prices are not subject to control without resorting to arbitrary methods. The author of the report asks how the Spanish administration could control the cost price of factories producing hundreds of different objects and which would be situated in a distant country.

Furthermore, the most rigorous surveillance of the administration over the affairs of private enterprises would not permit the determination of the extent to which the branch or subsidiary company was administered with absolute economic independence, or was treated as a part of the entire enterprise and managed in its general interest. All the *entrepreneurs* were unanimously of the opinion that, even if the profits of a branch of an enterprise were correctly accounted for, the accounting would not show the real economic significance of the branch in the entire enterprise.

The same was true of an enterprise which formed part of a community of interests (*communauté d'intérêts*). In dividing the total profits of a group of enterprises forming a community of interests, one resorted rarely to the profits as shown by the accounts. This experience was confirmed by the development of concerns (*Konzerne*). Consequently, if the Government were to tax

branches or subsidiaries in accordance with their real economic significance, it would be necessary to employ methods analagous to those employed for the division of profits between enterprises in such a group.

It is the existence of these concerns and their international operations, continues the author, which reduces to an absurdity, according to the opinion of Spanish experts, the system of separate accounting in a large number of cases. He gives as an example a certain group of enterprises in which each enterprise establishes its accounts according to identical principles agreed in advance. This accounting must show clearly the profits of each enterprise, but under other articles of the agreement all of these profits are pooled and finally redistributed in proportion to the capital stock in circulation. If in such cases, which become more and more numerous, the Spanish administration was bound to follow the accounts, it would take as a basis for taxation, not the real profits realised by the company, but an account of profits that it no longer possesses—that is to say, a figure absolutely imaginary. The Spanish legislature has therefore decided to apply to the taxation of the enterprise belonging to a concern the same principles of allocation as are in reality employed by the concern.

The author of the Spanish report also emphasises that cases of dumping must be especially considered. If the enterprises of one country force their branches or subsidiaries abroad to sell with little or no profit, or even at a loss in order to increase the prices at home, the true rôle and the significance of these branches and subsidiaries abroad will be absolutely ignored if one judges them by the small profit or loss that they make. It is for these reasons that the Spanish legislature has established the present system, which consists in always dividing the total revenue of the enterprise between the different countries in which it carries on business.

Spanish experts have agreed that there are a certain number of cases where the profits of a branch of an enterprise can be approximately determined without resorting too much to arbitrary methods and that the formula adopted should be large enough to allow for such cases. The problem has been resolved by dividing the total profits of the enterprise in such cases in proportion to the profits of the various branches. In such cases the system of apportionment and the system of direct assessment give the same result. This group of cases comprises principally the commercial establishments and, in particular, banks of deposit. It is in this field that branch accounting has an extended recognition in the Spanish regime.

With regard to subsidiary companies, one concluded that, if operations realised by an enterprise through a non-autonomous agent occasioned liability to tax under Spanish law, it was clear that, from an economic viewpoint, there is no agent less autonomous than a subsidiary company. There was so much fraudulent evasion through using subsidiary companies that opinion on this point was unanimous. The jurists in the Spanish Parliament, however, insisted that the law defined precisely the cases in which the administration would have the faculty of declaring that a company which was independent from a juridical viewpoint was, in fact, only a branch of another company or enterprise. The conditions imposed were as follows: In the first place, the administration should first make a declaration that the Spanish company formed a unit with the foreign enterprise, and that declaration could be made only if the Spanish company was in one of the following situations:

(a) When the directors of the company do not have Spanish nationality or if they have that nationality there are not a sufficient number of them domiciled in Spain to be able to make decisions;

(b) When the persons legally charged with the administration of the company are bound either by their position as officials or by contract to the foreign enterprise;

(c) When by the name inscribed in the register, or by additional indications which the company employs in its advertisements or any commercial documents, one may recognise that the company operating in Spain is dependent on a foreign company;

(d) When the administration is reasonably sure that the foreign company has control of a sufficient part of the capital stock of the Spanish company to impose its decisions in the general meetings of shareholders and in the commercial management of the company.

If the company accepts that declaration or, in case of a refusal, if the competent tribunal confirms the attitude of the administration, the Spanish company is subjected to tax as if it were a branch of the parent company.

The author of the report states that in no case has the administrative declaration been contested. The administration makes such a declaration only in very evident cases.

Difficult problems are presented by deductions made by the Spanish company from its income in order to make payments of various kinds to the foreign company, and which result in diverting the profits of the former. The principal deductions are the following: royalties for patents and trade-marks; important technical services, engineering and commercial services, plans and supervision. The commercial services include primarily the services of contracts of purchase and sale on the one hand and of financial services on the other.

The Spanish law does not contain any concrete rules for dividing the profits of an enterprise, but has established a committee of experts which is formed by two representatives of banking institutions, the Director-General of Public Revenue, the Director-General of the Stamp and Registration Taxes, the head of the department of Special Taxes on Companies and an expert of recognised authority. The law calls this committee a "jury", because it may only decide on the economic facts relative to the proportion of the profit realised in Spain, expressed as a percentage of the total income of the enterprise during a given period. This period is three years, but the enterprise has the right to request a revision if during it an important change has occurred in the business in Spain.

The decision of the jury is communicated to the taxpayer, and, if he refuses to conform to it, he is free to set forth his reasons. The Finance Minister gathers all the information he considers necessary and submits the question to the Council of Ministers. Any information submitted to the jury must be kept secret.

As an example of the application of the Spanish system, if a branch or subsidiary is administered in a way to assure for itself the largest possible profit, the commission of experts takes as a basis a relative figure. If the branch realises a profit of 2.5 million pesetas and the total profit of the enterprise in the same period, computed in accordance with Spanish law, is 33 million French francs, which at the rate of exchange on the date of fixing the balance-sheet makes 10 million pesetas, the commission of experts fixes the relative figure of that enterprise at 25 per cent—*i.e.*, 25 per cent of the total profits of the enterprise are taxable in Spain, which makes a taxable profit of 2½ million pesetas.

If a Spanish subsidiary does not come within the requirements for treating it as a branch of the foreign company, it is taxed in the same manner as any other Spanish company.

The verification of the accounts of the foreign company is made under the same conditions as that of national enterprises. The balance-sheet and the accounts and records of the mother company must be authorised by competent representatives of the company and their signatures legalised in the ordinary manner. A large number of foreign enterprises, having their centre of management in a country in which accountants are recognised, submit the certificates of such accountants with their accounts. The commission of experts attaches much value to the assessments made by the fiscal administrations of the countries of origin. Moreover, the commission of experts always takes into account the differences in the concept of income in the laws and regulations of the interested countries.

If the commission of experts has the unanimous conviction that the branch or subsidiary is administered with complete economic autonomy but that its accounts are not sufficient to reveal the Spanish profit, it may resort to indirect methods; but even in this case the administration seeks only to tax the real Spanish profit of the branch or subsidiary company.

In some cases, where the branch or subsidiary company is managed with absolute economic independence and has a satisfactory accounting, the administration does not rely on the accounts. This is especially true in the case of enterprises manufacturing in a foreign country and selling in Spain.

The Spanish administration seeks to separate the sales profit from the manufacturing profit without going into the question of the cost of manufacture. The apportionment of the sales profit in Spain and other countries is then made on the basis of the respective volumes of business, taken separately or in combination with other factors in order to take into account the special situation of the different national markets in which the enterprise operates. This special consideration of the different situations of markets is very important in Spain, because the phases of the Spanish economic cycle are, as a general rule, behind those of other countries.

If the Spanish administration is aware that the branch or subsidiary is not managed in an autonomous fashion but in the interest of the entire enterprise—that is to say, if there is an economic unity between them—the apportionment of profits is made on the basis of the actual facts. In the case of a subsidiary company, the administrative officials make the necessary declaration, and, if it is accepted or upheld, the commission of experts endeavours to determine the relative importance of the subsidiary in the concern as a whole. Such declaration is not necessary in the case of a branch.

The commission of experts takes into account the particular circumstances of each case and chooses its method in accordance therewith. There is no formula nor rule of thumb. Nevertheless, the commission follows certain general criteria, the most important of which are the following: In the first place, the jury asks itself, Does the Spanish establishment form a part of a concern in which the profits will be pooled in order to be subsequently distributed according to certain agreed methods? If this is the case, the commission of experts calls upon the legal representatives of the enterprise to communicate the agreed rules of distribution. The enterprise is advised that it is not obliged to furnish information if it feels it should not do so, and, if submitted, the information is kept secret.

Having been advised of the plan of distribution of profits, the commission of experts apportions them in accordance therewith. If the enterprise does not belong to such a concern, the jury itself establishes a plan of distribution and proceeds in the spirit of business men who would actually effect such a distribution. For this purpose, the jury asks itself if the operations of the Spanish establishment are of the same nature as those of the foreign establishment of the same enterprise.

If the business of the Spanish establishment is similar to that of the other establishments of the foreign company, one determines the relative importance of the Spanish establishment in accordance with the importance of its operations. For example, in the case of a manufacturing enterprise in which the fixed capital is preponderant, then the real assets come first into consideration. Nearly always other factors are taken into account, such as the pay roll, the raw materials, the frequency of the services rendered by the enterprise, the expenses, rent, sales, etc.

If, on the contrary, the enterprise is engaged in selling or in similar transactions in which the liquid capital plays a preponderant rôle, it is the turnover which is almost always used as a basis of assessment, together with one or several of the factors which have just been mentioned. It has been stated above that the economic cycle in Spain does not synchronise with that abroad. One takes into account that difference in every case where it exercises an appreciable influence on the business of the enterprise in question.

As a general rule, the facts which should serve in making the assessment are indicated by the very nature of the enterprise, but difficulties arise in some cases. In such cases, the interested parties are invited to discuss their situation with the experts of the jury, which is empowered to call disinterested experts. According to the Spanish report, if the facts in question satisfy the conditions necessary for the application of the method, one applies mathematical statistics to evaluate the facts proposed as a measure of operations.

The greatest difficulties with which the jury must deal are those in cases where the enterprise has in Spain establishments which carry on operations different from those of the other establishments abroad. The most frequent cases of this nature are those in which the enterprise has its manufacturing establishment abroad and merely sells in the Spanish establishments the merchandise produced by the former, and *vice versa*. The Spanish method excludes systematically as a futile and valueless detour the determination of the cost price. It therefore remains to determine what is the respective economic significance of manufacture and of sale in the entirety of the enterprise. Important examples of enterprises of this class include those which buy some famous make of sherry wine for which they themselves establish the production and sale on all the markets of the world. Again, there is the example of mining enterprises.

It is possible to determine for a given quantity of products the profits of production for a series of years, usually three, and by making the same calculation for the sale, one ascertains the relation between the profits of production and the profits of sale for the given quantity of products. This relative figure is then employed to effect the apportionment.

In other branches of commerce there is established in practice a certain rate of commission which includes certain sales expenses. It is then necessary to determine what is the part of the risk and of the expenses which falls on the producer: if the risk is negligible, then the method applies with great exactitude and the division between the manufacturing profit and sales profit is thus realised. In a more important category of cases, embracing enterprises which manufacture and sell articles through establishments which perform only one of the two operations, the jury approach the problem in the same manner as it would when taxing a concern representing a vertical organisation, including the sale of goods.

The methods employed by the jury are exactly analagous to those employed in business practice, and it is because of such cases that the Spanish legislature recognised the necessity of placing on the jury important Spanish financiers and other experts with a great experience. When these experts have studied the particular case and have made a first attempt to find the most just formula, they call in the representatives of the enterprise either to appear in person or to send in a written report, and the experts of the jury discuss with these representatives the proposed formula. It is very rare that they do not reach an agreement. If a disagreement occurs, disinterested experts are called. One seeks to deal directly with them in the absence of the representatives of the enterprise in order to avoid the acquisition by third parties of knowledge of the situation of the enterprise more than is necessary. Very frequently it is possible to decide the question by the employment of mathematical statistics.

The application of the Spanish system in the case of banking and insurance companies will be treated further on in the discussion of the systems employed in the five countries for taxing such enterprises.

(b) *French System of Fractional Apportionment.*

The system of fractional apportionment is also regularly employed by France in the imposition on foreign companies of its tax on income from securities. The reason for this imposition is that French companies are required to withhold at source a tax on dividend and interest payments, in addition to the tax assessed on its industrial and commercial profits as such. To place a foreign company exploiting property in France in a similar situation, and to reach that part of its distributed income which is deemed to have been derived from French sources, the foreign company is required to pay this tax on the same proportion of the dividends distributed or interest paid at its seat abroad as its assets in France bear to its total assets. This taxable quota (*quotité imposable*) is fixed for a period of three years, and the tax is due in respect of dividends distributed or interest paid during each fiscal year of the company. It is presumed that the taxable proportion of these payments has been derived from French sources, even though, in fact, during the year in question no income was received from such

sources. On the other hand, if the foreign company makes no such payments, no tax is due, even though the French branch or subsidiary was productive of revenues.

The French report declares that this method of taxation is essentially arbitrary and has the advantages and disadvantages of such a method of assessment. The administration must employ it even when disadvantageous, and companies must submit to it even when its results do not conform to the real state of affairs. The French report observes that this method protects the fisc from operations tending to reduce the profit realised in France, and also, for the purposes of this tax, frees the branches or subsidiaries in France from investigation, except for the valuation of the French assets or business in determining the taxable quota.

In determining the taxable quota, one ascertains the respective value of French assets and total assets on the basis of the balance-sheets established for France and the general balance-sheets. This value is the real or sales value of all assets without deduction of any debts or charges affecting them. Nevertheless, to obtain the value of the French assets and that of the total assets, it is not sufficient to add the assets of each balance-sheet and to determine the proportion. It is also necessary to ascertain if each of the items corresponds to a real asset and to eliminate those which represent only suspense accounts (*comptes d'ordre*), such as the cost of first establishment.

It is furthermore necessary to verify if the assets listed under the same heading in the two balance-sheets have a certain nationality and if they belong to each installation, and to withdraw those which have an uncertain nationality or which are common to the French and foreign exploitations, such as the value of a patent or industrial process; in this case, one presumes that these assets form part of the French assets in the same proportion as the other assets.

In order to give the taxable quota its arbitrary (*forfaitaire*) character, the authorities examine the balance-sheets of the three preceding years to determine the average of the variable values (merchandise in stock, cash, debts, bills of exchange, etc.). To this average is added the value of the real assets at the close of the last balance-sheet, and, on the basis of the total thus obtained, the proportion between the value of French assets and the value of the total assets is established.

The indications on the balance-sheet serve most frequently as a basis for fixing the taxable quota, subject to the right of verification by the administration. If it is established, for example, that French real estate has been entered in the balance-sheet at a valuation much lower than its real worth, the administration has the right to substitute therefor an estimated value, taking into account the appreciation of the French assets. In the same way, foreign companies may, on the condition of submitting necessary evidence, demand an increase in the valuation over that indicated in the balance-sheets of certain of their foreign assets, in order that the proportion serving as a basis for the taxable quota may more nearly approach reality.

When the foreign company does not establish a special balance-sheet for its French exploitation, it is invited to make its own valuation, subject to the right of verification by the administration, of the part which the value of the French assets represents in the different headings of its general balance-sheet. In this way there is established for the French branch a fictive balance-sheet, which is used to make a comparison of the assets of the branch with those of the entire enterprise.

If a foreign company has a French subsidiary, the taxable quota is established in the same manner, but one takes as the comparative value of the French assets only that which corresponds to the rights of the foreign company in the subsidiary. Thus, if the foreign company possesses eight-tenths of the shares of the French company, the value of the French assets is eight-tenths of the estimated value of the assets of the French company. The estimate of the value of the assets of the French company is most frequently made on the basis of the balance-sheet of that company; but if this company has attributed to its shares, notably for the purpose of payment of taxes due, an estimated value superior to that which results from the indications on its balance-sheet, it is that estimated value which will be taken to determine the worth

of the capital stock, and, consequently, the value of the participation of the foreign company.

When a foreign company merely sells merchandise in France and has there no other industrial assets, the taxable quota is fixed in accordance with the relation existing between the amount of its French transactions and that of its total transactions. The nationality of the transaction is determined by the place where the contract is concluded.

Where a foreign company rents real estate in France in order to manufacture there merchandise intended for sale, the taxable quota is fixed by comparing the value of the French assets with those of the total assets used by the company and the amount of the French transactions with the total transactions. The average between these two proportions is taken as the taxable quota.

Although these two preceding methods are those most frequently employed, the special circumstances of a given enterprise may necessitate some derogations. The methods employed for banking, insurance and other types of enterprises will be described below under the appropriate headings.

(c) *German System of Fractional Apportionment.*

Although the German administration imposes income tax on a separate calculation of local income wherever possible, instances may arise where the German income is computed as a fraction of the total net profit of the enterprise on the basis of factors which are of primary importance in the earning of the profits. There are no special rules, either statutory or administrative, governing the choice of the factors which are to be employed in ascertaining the profits.

The selection is within the discretion of the competent fiscal authorities, whose decision must depend on what is just and fair. In the case of enterprises in general, and in the case of commercial enterprises including banks, the ratio of gross receipts realised in Germany to total gross receipts is employed, and, in the case of insurance companies, either the preceding method is used, or the ratio of premium income in Germany to total premium income. For other kinds of enterprises, the tax authorities employ the ratio of salaries and wages paid in Germany to total salaries and wages paid, excluding directors' percentages (*Tantiemen*) paid out of profits. If the preceding factors cannot be ascertained, or do not provide a reasonable basis for apportionment, the assessing authorities select factors according to the circumstances of the particular case.

(d) *British Use of Fractional Apportionment.*

There is no provision in the income tax law of the United Kingdom for fractional apportionment, although it may be employed in some cases where the methods of separate accounting or of taxing on a basis of a percentage of turnover fail to yield satisfactory results. For example, one might employ in the case of banks the ratio of United Kingdom assets in determining the proportion of the total profits which should be taxable in the United Kingdom.

(e) *American Formula for Fractional Apportionment.*

Under the United States income tax law, if an enterprise produces or manufactures goods in the United States and sells them abroad, or *vice versa*, and if no independent factory price has been established, it is provided that profits shall be apportioned between the United States and the foreign country concerned in accordance with a specific formula (Regulations 74, Article 682, case 2 A). The net income of the enterprise is divided into two parts: one-half is apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country; the remaining half is apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country. The

term "gross sales" refers, however, only to the sales of personal property produced in whole or in part by the taxpayer within the United States and sold within the foreign country, or *vice versa*, and the term "property" includes only the property held or used to produce income which is derived from such sales. As the taxpayer who cannot establish an independent factory price may nevertheless apply for permission to base his return upon his books of account, which are regularly kept and contain a detailed allocation of receipts and expenditures which reflects his true income more clearly than the preceding methods, there have been very few instances in which the apportionment fraction has been employed.

The law and regulations also provide apportionment fractions for life insurance and transportation enterprises, but these also have infrequent application because of special circumstances which will be indicated below in the paragraphs dealing especially with these types of enterprises.

4. RELATIVE EXTENT TO WHICH THE VARIOUS METHODS ARE EMPLOYED.

Of the five countries in question, three (Germany, Great Britain and the United States) normally tax local branches or subsidiaries of foreign companies on the basis of their separate accounts, and a fourth country (France) uses this method for its tax on industrial and commercial profits. Although the Spanish law requires that, in all cases, the branch of a foreign company shall be taxed in accordance with a percentage of the total income of the enterprise, in practice the accounts of the Spanish branch play an important part in determining the proportion of the entire profit that is attributed to the branch; and, if the branch is practically autonomous, the income shown in its regularly kept books is usually taken as the basis for taxation, even though the jury computes the percentage which this amount bears to the total income and formally makes the assessment in accordance with that percentage.

In other words, if an enterprise deals with its branch in a foreign country as if it were an independent entity, and if the books of the branch are properly kept so as to reflect the true income from these transactions, then the separate accounting of the branch is evidently regarded by most, if not all, of the five countries as the simplest and most satisfactory method of taxing profits. This observation must be qualified, however, in so far as Spain is concerned, by stating that, even though the true profits of a Spanish branch are reflected in its books, the law requires that in every case the relative importance of these profits with those of the entire enterprise be determined. Although this determination is not likely to result in an increase in the assessment of the income of the Spanish branch, it may cause a reduction in the assessment, according to the Spanish report, if the enterprise as a whole has realised a proportionately smaller income or no income at all.

When not satisfied that the true profits are shown by separate accounting, the tendency of four countries (France, Germany, Great Britain and the United States of America) is to resort at once to the "percentage of turnover" method. Whereas, in the first three countries mentioned, this percentage of turnover may be used as a basis of assessment, in the United States it is generally employed only as a lever to force the taxpayer to reveal further information concerning his business so that the accounts may be adjusted to reflect the true income. In one country (Germany), taxation on the basis of an agreed amount or percentage of turnover (*Pauschbetrag*) for a period of three to five years is frequently resorted to, and in another country (Great Britain) it has a more limited use.

Whereas the method of fractional apportionment is regularly employed for levying the profits tax in Spain, and may be resorted to in the other four countries, the last-mentioned do not ordinarily have recourse to this method unless it is impossible to assess tax by employing the separate accounting or "percentage of turnover" methods.

The British report states that about 55 per cent of the total cases are settled on the basis of separate accounts, possibly after some adjustments, and that the "percentage of turnover"

method is employed in about 20 per cent of the total cases ; other conventional methods are used in the remaining 25 per cent. The French and German reports do not give the relative extent of the employment of the different methods, but the American report states that separate accounting, subject to adjustments, is employed in practically every case. The following observations are taken from the various reports concerning the relative merits of the different methods :

1. The method of separate accounting is considered to be the best method provided, of course, it reveals the true profits. Among the other methods, the most practical appears to be that of determining the profits on the basis of the turnover, either applying the average percentage of net income realised by similar enterprises or by applying the percentage of gross profits realised by similar national enterprises and deducting therefrom the cost of the local establishments. The reason for this observation is that this method does not necessitate consulting the accounts of the foreign enterprise (French report, page 80).

2. No empirical method is satisfactory for all cases, but reasonable results can be obtained in particular cases by assessing a profit equal to that of a similar independent German enterprise or to the normal rate of interest of the capital invested (German report, page 119).

3. The separate accounting method is considered to be the most satisfactory. Where there are interlocking transactions between the branch or subsidiary company and the foreign parent, and no agreement can be reached between the taxpayer and the authorities as to the treatment of these transactions and the separate accounting method consequently fails, then the "percentage of turnover" method is most frequently adopted. This, it is suggested, is the most convenient alternative method for manufacturing and merchanting business where a turnover test, taking one year with another, is likely to give fairly satisfactory results. Where the separate accounting method has failed and the Turnover method cannot be applied owing to the nature of the business (*e.g.*, banks, insurance companies, etc.), the best available method of apportionment for the particular industry is followed—*e.g.*, an assets basis for banks, a premium basis for insurance companies, a train-mileage basis for railways, a freight basis for shipping, etc. In the absence of any better evidence, these are likely to give fairly satisfactory results, taking one year with another, and it is certainly an advantage to have some definite method agreed on between the taxpayer and the revenue authorities (British report, page 192).

4. The numerous arguments presented by the Spanish report in favour of the system of fractional apportionment may be summed up as follows :

(a) It is the only system which assures that the enterprise will be taxed according to its real capacity to pay, and consequently precludes the overlapping of assessments, resulting in the taxation of more than 100 per cent of the income ;

(b) This system is the only one which permits the taxation of the branch or subsidiary in accordance with its real importance in the enterprise as a whole.

5. The method of separate accounting is, in general, the preferred method in the United States, and in the only classes of business in which the law permits the employment of two other methods, those of buying or selling, or of producing and selling, the "percentage of turnover" method is considered more practical than that of fractional apportionment ; because, with this method, a check on the facts on which it is based can be made within the country wherein the taxable income arises, and there is, furthermore, less likelihood of error in the facts themselves and less difficulty in analysing them. This method may not be technically free from error, but for the classes of business to which it applies—*e.g.*, industrial and mercantile—it forms a reasonable substitute for fair invoicing and for the keeping of inventories, as well

as for proper accounting in respect of the related businesses to which they apply. The formulæ authorised in the American law for shipping and insurance companies are intended to meet particular situations and cannot be compared with methods applicable to other business. In general, it is believed that fractional and empirical methods should be used only as a last resort, as in some instances they tend to spread inequalities on an even basis, whereas such inequalities should be localised and remedied through the proper keeping of accounts. In other instances, they distort or throw profits where they do not belong under actual economic circumstances (American report, pages 249 and 250).

The French tax on income from securities cannot be compared, strictly speaking, with the preceding levies on profits, because the basis of the tax is a certain percentage of dividends and interest paid by a foreign company, the percentage being determined by the ratio of assets in France to total assets. As is stated in the French report, the tax is due when the foreign company pays dividends or interest, even though the taxable proportion of the dividends or interest was not actually derived from French sources. Consequently, it is not within the category of taxes for which profits must be allocated or apportioned, but belongs in a category by itself. As is shown in the French report, the net profit is never taken as a factor in determining the taxable quota, on the basis of which the dividends and interest of the foreign companies are taxed.

5. APPORTIONMENT BETWEEN BRANCH OR SUBSIDIARY AND PARENT ENTERPRISE.

(a) *Apportionment of Branch Profit to Real Centre of Management.*

A part of the profit derived by a local branch of a foreign enterprise is not specifically ascribed to the real centre of management abroad under the law of France, in so far as the commercial profits tax is concerned, as well as under the laws of Germany, Great Britain and the United States. The profit of the local establishment is assessable in full without allowing for any allocation of a proportional part to the real centre of management abroad. In the case of the French tax on income from securities, which is assessed on a taxable proportion of the dividends and interest paid by the foreign company, the question obviously does not arise.

Under the Spanish regime, however, the practice is always to ascribe a fraction of the profits to the real centre of management abroad. This practice follows directly from the definition of a permanent establishment in Spanish law and from the principle of the fundamental equality between a Spanish enterprise operating abroad and a foreign enterprise operating in Spain. The exact amount assigned to the centre of management is fixed by the experts, taking into account the part played by the centre of management in the general business. If the centre of management exercises only a certain control and the branches are largely autonomous in their management, the figure is about 10 per cent. This figure increases in amount as the rôle of the centre of management becomes more important, and approaches one-half of the profits when the business of the company is such that its success depends fundamentally upon the efficiency of the direction.

(b) *Allocation of Interest on General Indebtedness.*

With regard to interest on general indebtedness and the general overhead of a foreign enterprise, the practice in most of the five countries is to make some allowance in computing the taxable profit of the local establishment. In so far as interest on general indebtedness is concerned, the French administration, in imposing the tax on industrial and commercial profits, follows the rule that, if a foreign enterprise contracts a debt especially for the operation of a specific establishment, the total interest charge must be included in the expenses of that

establishment. If, on the contrary, the debt was contracted for the needs of the enterprise as a whole, the interest charge must be apportioned between the various establishments, in accordance with the amount of the money which may be regarded as especially used in the operation of that establishment.

No such deduction is allowed, however, for the tax on income from securities, as that tax must be withheld from all interest paid on money borrowed by the foreign company, regardless of the place where, or the purpose for which, the loan was contracted.

The German principle is that, if it is possible to assess a local branch of a foreign enterprise on the basis of its accounts, one can deduct an interest charge which is economically connected with the income of the German establishment. If there is no economic connection between the indebtedness and the income, the interest can be distributed on a reasonable basis—for example, in proportion to the gross income or to the assets allocable to each of the interested countries.

As the British law, in accordance with its policy of taxing wherever possible at source, does not permit the deduction of debenture or annual interest in determining the amount of assessable profits, a foreign enterprise is not allowed to deduct a portion of the interest on a loan contracted abroad from profits of its British establishment.

The American administration allows the distribution of interest between the real centre of management of a foreign enterprise and the branches in America in accordance with the relative place of employment of the funds borrowed. A rateable part of the general interest charge is deductible from the gross income of the branch under Section 119 (b) of the Revenue Act of 1928 and Article 680 of Regulation 74. In practice, this deduction is often claimed by foreign companies.

(c) *Allocation of Overhead Expenses.*

As regards the general overhead expenses of the real centre of management abroad of a foreign enterprise, such as remuneration paid to directors, general administrative expenses, the cost of centralised accounting and other expenses pertaining to the general business of the enterprise, a proportionate part may be deducted in calculating the income subject to the French tax on industrial and commercial profits. This proportionate part is usually determined by the ratio of the turnover of the French establishment to the total turnover. This method of apportionment does not apply where the expenses can be definitely allocated, such as where there is maintained at the centre of management a service occupied exclusively with the French operations and treated separately in its accounts.

No consideration is given to this question in determining the taxable quota for the purposes of the French tax on income from securities.

The British report notes that, in practice, foreign manufacturing enterprises frequently include in the invoice price of goods shipped to the British branch a proportion of head office expenses, and consequently there is no question of a specific allocation of such expenses. In other cases where an allowance is made, the overhead expenses are usually apportioned by reference to turnover or some other factor which is appropriate to the particular case.

Even in the case of banks, insurance companies, and other non-manufacturing enterprises, continues the British report, specific claims to deduct a proportion of such expenses are exceptional. Where the foreign enterprise is assessed on a conventional basis—for example, in the ratio of premiums for insurance companies or of assets for banks—the overhead expenses would usually be taken into account in arriving at the total profits of the concern, and, consequently, in apportioning a part thereof to the United Kingdom. In the case of a few insurance companies taxed on a premium ratio, a specific allowance—for example, 2 per cent—has been made for general overhead. Occasionally, banks have been allowed a deduction of the same proportion of overhead expenses as the London branch expenses bear to the expenses of all branches.

Under the same provision of the United States law mentioned above in connection with interest on general indebtedness, a foreign enterprise may deduct from gross income from United States sources a rateable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. This rateable part is determined by the ratio of gross income from sources within the United States to total gross income.

(d) *Apportionment of Net Profit of Branch or Subsidiary to Deficitary Parent or vice-versa.*

As a general rule, in each country which taxes the local subsidiary company or branch of a foreign company on the basis of its own accounts, no account is taken of the profit or loss realised by the foreign enterprise as a whole. On the other hand, if the method of fractional apportionment is employed—as in Spain and possibly in Germany, when the economic unity theory is invoked—the profit of the branch or local subsidiary may be set off against the loss of the entire concern, or vice-versa.

The French tax on industrial and commercial profits being levied in accordance with the principle of territoriality, a local establishment is assessed as a separate entity. As the tax on income from securities is payable on the taxable proportion of dividends or interest paid by the foreign company without reference to amounts derived from French sources in the same year, it may happen that tax will be collected even though the French establishment realises a deficit.

The Spanish regime taxes the local branch on the basis of a certain percentage of the total profits, but if this method of assessment results in a loss for the branch, the branch must nevertheless be taxed on its relative percentage of the amount representing 3 per 1,000 of the capital of the company (the minimum rate for companies). If the foreign company realises a profit as a whole, whereas the subsidiary company in Spain, which is managed with an absolute economic independence, suffers a loss, no tax would be imposed except for the proportionate part of the minimum tax of 3 per 1,000 of the capital.

The United States of America allows, in computing the net income of a domestic branch of a foreign corporation, a deduction of any loss directly allocable to the United States, and also a ratable portion of the loss which cannot be allocated to any definite source (Revenue Act of 1928, Section 119(b) and Regulations 74, Article 680). If, however, after the application of this provision, the foreign corporation as a whole suffers a net loss, whereas the branch in the United States realises a net profit, no part of the net loss of the foreign corporation can be allocated to the branch.

6. APPLICATION OF THE ALLOCATION METHODS IN SPECIFIC CASES.

In general, the only particular kinds of enterprises for which special rules of allocation have been drafted are insurance companies (France and the United States of America) and transportation enterprises (United States). Otherwise, enterprises engaged in banking or supplying electricity and gas, telegraph and telephone enterprises and mining enterprises are subject to the ordinary regime for taxing foreign enterprises, except for special elements that may be taken into account when the income of the local branch or subsidiary is determined by empirical or fractional methods.

In other words, in France for the purpose of the commercial profits tax, Germany, Great Britain, and the United States, these enterprises are taxable, in principle, on the basis of their own accounts. In determining the taxable quota for the French tax on income from securities, and in determining the percentage of total profit subject to the Spanish tax, each country takes into account the character of the assets or other elements, such as turnover, which are appropriate to the particular kind of enterprise.

(a) *Industrial and Commercial Enterprises.**Selling Establishments.*

Local Establishments selling in National Market. — Profits derived by foreign enterprises from selling through a permanent establishment are taxable in all five countries, and the assessment of such profits raises the most important and difficult questions in the whole field of allocation. A distinction must be made between the selling of goods which are purchased abroad and the selling of goods which are manufactured abroad. In general, each country takes as the basis of taxation, in the case of the sale of goods which have been purchased abroad, the entire profit, less cost of purchase, transportation, etc.

In the case of establishments selling goods manufactured abroad by the enterprise, each country seeks, in principle, only to tax the merchanting or sales profit realised within its territory, allowing to the foreign country of manufacture an appropriate manufacturing profit. In France, Germany and Spain, this principle of division is a corollary of the fundamental principle that a permanent establishment should be taxed only to the extent of its activities, and, if the activities are restricted to the sale of goods, only the profit directly attributable thereto should be subject to tax.

The British Income Tax Act 1918, General Rule 12, provides that, where goods are manufactured or produced abroad by a foreign concern, it may, at its option, be subject to the United Kingdom tax on the basis of the "merchanting" profit realised in Great Britain. This allows for the allocation of a manufacturing profit to the foreign country where the goods were produced. The United States embodies this distinction in Article 682 of Regulations 74, which allots, if possible of ascertainment, an independent factory profit to the foreign manufacturing establishment.

As has been previously indicated, the usual procedure in assessing tax on the selling establishment, for the purposes of the profit tax in each of the countries mentioned, is to require a declaration of income supported by accounts referring to the establishment. If the foreign enterprise has invoiced goods to the local branch or subsidiary at a fair market or independent factory price, and the fiscal authorities are satisfied that such is the case, no difficulties arise. Where goods have been invoiced to the branch or subsidiary at a price which leaves little or no sales profit to the branch, then the tax authorities resort to the "percentage of turnover" or other empirical methods described.

For the purposes of the French tax on income from securities, it is unnecessary to make the distinction between manufacturing and sales profit, as the taxable quota is fixed by other factors. If the foreign company sells, both in France and abroad, goods which have been bought or manufactured abroad, the taxable quota is fixed in accordance with the proportion of the sales in France to total sales. Where the company only sells in France goods which it has bought abroad, the quota is determined by comparing the amount of the sales in France to the total purchases and sales. If the company merely sells in France merchandise which it has manufactured abroad, the quota is established in accordance with the ratio of French assets, including clientele, stocks, material, accounts receivable, goodwill, credits, etc., to the total assets.

The Spanish system generally recognises the division of the profits between manufacture and sale, and employs a number of practical criteria for effecting the apportionment between the Spanish sales establishment and the foreign manufacturing establishment. The separate accounting of the establishment is seldom taken as a basis for fixing the relative percentage of business done in Spain because of the impossibility of verifying the cost price abroad. If the business is of a nature for which definite rates of commission have been established in practice—for example, fine wines and books—the experts of the jury augment the commission by the expenditures and economic charges which must be borne by the producer and subtract

therefrom the costs of selling incurred by the enterprise ; the difference is taken as the average commercial profit. This commercial profit is then divided between Spain and the foreign country concerned. In other cases, one endeavours to ascertain the respective profits of manufacture and sale realised by independent enterprises in respect of a given volume of goods. If there is no appreciable difference in the risks incident to manufacture and sale, one divides the profit in proportion to the capital employed by each establishment. The most important problem is that of the division of stocks between the factory and the establishment of sale, and the difficulties are enhanced where the enterprise makes instalment sales. The accounts of amounts owed by purchasers and goods in stock have their principal corresponding entry in the account of the amounts credited by the home office to the branch. But, in the case of ordinary sales, the division of stocks is the object of a special appraisal by experts of the jury and of the enterprise.

With regard to the differences of risks, it must be observed that the Spanish jury does not consider this element unless it is very clear, as the jury does not, in practice, charge the accounts of a foreign enterprise with items which are doubtful.

If an enterprise manufacturing abroad also sells in Spain merchandise which it has purchased abroad or in Spain, one separates the two categories of transactions, and an apportionment is made of the sales costs between the respective categories.

Local Establishments selling Abroad. — By virtue of the principle of taxing activities of a permanent establishment, France and Germany ascribe to the local permanent establishment of a foreign enterprise profit derived by that establishment from sales in a third country where there is no permanent establishment. For the purposes of the French tax on income from securities, the transaction is French if concluded in France. The Spanish report states that operations effected outside of Spain are always allotted to the real centre of management, even though they might be reflected in the books of the Spanish branch. Under the British law, where the enterprise is managed and controlled abroad, there would normally be no liability to British tax in respect of profits made by the local establishment for sales in a third State. In the case described, the United States authorities would ascribe the profits to the place of sale in the third State.

Manufacturing Establishments.

In all five countries, profits derived from manufacturing within the country and selling abroad are taxable. In France, Germany and Spain, this liability arises because of the carrying on of commercial and industrial activities through a permanent establishment within the country. In regard to this point, the British Royal Commission on the Income Tax, which reported in 1920, said that, where a British resident agent of a foreigner who purchases goods in the United Kingdom subjects them there to processes akin to the processes of manufacture, and eventually sells them to his principal abroad, it should be possible for the foreign principal to make application that the profits assessed in this country should be the manufacturing profit, as distinct from the merchanting profit which he makes by selling the goods abroad.

A profit is ascribed to the manufacturing establishment in the United States in an amount determined in accordance with one of the following methods :

- (1) Either by an independent factory price established for like sales within the United States ; or,
- (2) If no such price is determined, by apportioning the income on the basis of property and gross sales ; or,
- (3) By a fairer showing of the taxpayer's books of account (Regulations 74, Article 682).

Buying Establishments.

In France, Germany and Spain, income tax may be imposed on enterprises purchasing goods through a permanent establishment in order to export them for use or sale by other establishments abroad. Under British and American law, however, no income is deemed to arise from the mere purchase of goods, and therefore no tax is payable.

The reason for this difference is that the basic principle of liability to tax in the three continental European countries mentioned is that the income tax is payable when commercial activities are carried on through a permanent establishment. Furthermore, as is expressed in the French report, it is considered that a part of the profit resulting from the resale of the goods is due to the conditions of purchase. On the contrary, a British court has held that mere buying in the United Kingdom by a foreign enterprise does not constitute trading within the United Kingdom, and therefore no tax is payable (*Sully v. Attorney-General*, 2 T.C.149).

The United States Revenue Act of 1928, under Section 119 (e), specifically provides that income derived from the sale of personal property within, and its sale without, the United States shall be treated as derived entirely from sources within the country in which sold.

A further interesting distinction between the law of these two groups of countries concerning this point is that, for the purposes of the French tax on industrial and commercial profits, and the income taxes of Spain and Germany which are imposed when a foreign enterprise has a permanent establishment in each of the countries mentioned, it is immaterial where the contract of sale takes place. Liability arises because of the permanent establishment having been instrumental in the purchase or sale. Under British and American law, however, it has been held that the sale takes place where the contract of sale is concluded. Thus, the communication in England of the foreign seller's acceptance of a British customer's offer to buy constitutes the conclusion of a contract in that country (*Belfour v. Mace*, 13 T.C. 555; for the United States, see General Counsel's memorandum 8594, IX-44, 4819).

Although the French law does not take into account the place of acceptance of the contract for the purpose of the tax on commercial and industrial profits, it does take such juridical facts into account for the purposes of the tax on income from securities. If two signatures are necessary for the conclusion of a transaction, the transaction is considered French if the second signature, in point of time, was effected in France; if the second signature was placed on the contract abroad, then the transaction is foreign. If the agreement is not represented by any written document, then the transaction is French or foreign in accordance with whether the offer to purchase or sell was accepted in France or abroad.

If a foreign enterprise has a purchasing establishment in France, it is subject to the tax on industrial and commercial profits on an amount which corresponds to the commission which would be realised if the purchasing establishment were acting for the account of third parties, and to tax on income from securities on the same proportion of dividends or interest paid as the amount of working capital of the buying establishment bears to the total capital of the company.

When the German administration imposes a tax on the local purchasing establishments of foreign enterprises, it ascribes to the establishment, as a general rule, an amount corresponding to the commission which an independent purchasing agent would receive.

The Spanish authorities consider the transaction of purchase and sale in its entirety, and endeavour to ascertain the relative importance in commercial practice of each operation. In general, it is considered that purchasing is less important than the sale of goods in the case of most kinds of merchandise. In fact, certain rates of commission have been determined and are regularly applied by the experts of the jury. Nevertheless, there are certain exceptions, as in the case of enterprises purchasing the essence of mountain flowers, where the act of purchase is much more important than that of sale, because the purchase requires an extensive and costly organisation, whereas the selling transaction is very simple.

Service Establishments.

With regard to establishments of a foreign enterprise which do not directly engage in activities productive of profits but render services to the enterprise which contribute indirectly to the realisation of profits—for example, a statistical bureau, a display room—no definite rules of liability exist in any of the five countries. According to the fundamental principle of British law, no tax would ordinarily be imposed on such an establishment, because no profits would be derived unless payment were received for the services rendered. The same rule obtains in the United States.

Where the concept of taxing the commercial activities of a permanent establishment prevails, as in France, Germany and Spain, liability might arise, but this would depend upon the facts of the particular case. For example, the French report states that, if a foreign enterprise possesses in France an office charged exclusively with furnishing statistical information or information on the needs of a market, on the possible outlet for certain articles, on prevailing prices and the volume of sales made in France by competing enterprises, on the amount of credit that might be extended to purchasers, etc., such enterprise might be subjected to the tax on industrial and commercial profits on the basis of a profit corresponding to that which an independent agency would make from furnishing the same information to third parties. Similarly, if a foreign enterprise has a display room bearing its name, in the charge of an agent who does not make sales but supplies information to the foreign enterprise, then the company must be considered as having an establishment liable to the commercial profits tax. Although the bureau administering the tax on income from securities has not yet had such a case, its attitude is that, if a foreign company merely has an information office or a display room which does not effect transactions within the object of the company, or does not receive orders, it would not be subject to tax. If the activities of the French establishment were considered to be within the objects of the company, the taxable quota would be fixed in accordance with a comparison of the French assets to total assets, or the expenses of the French establishment to total expenses, or in accordance with some other criteria giving a result conformable with the real situation.

(b) Banking Enterprises.

In determining the taxable quota for the French tax on income from securities with regard to banking enterprises engaged in France only in making loans to individuals or companies, the taxable quota is determined by the ratio of loans in France and the value of the total assets. The amount of the loans is indicated by a detailed statement of the French loans and the names of the borrowers. If a foreign bank establishes in France a branch charged with carrying out operations of all the kinds in which the enterprise engages, the taxable quota is, in principle, determined by the proportion of working capital (*fonds de roulement*) employed by the French branch, with the total capital. If the French branch has no working capital or if the amount of working capital is not sufficient for the transactions effected, the tax authorities ascertain the ratio of French gross receipts to total gross receipts.

In Germany, if it is impossible to assess the local branch of a foreign bank on the basis of its own accounts, the authorities may determine the income of the German branch on the basis of the ratio of gross receipts in Germany to total gross receipts.

Except where special rules have been prescribed by international treaties, for example in the treaty with England, the practice of the Spanish administration is first to determine the degree of economic autonomy of the branch of a foreign bank. If the branch carries on its loan and credit transactions out of its deposits and amounts borrowed in Spain, the real profits are decisive in fixing the relative percentage by the jury, subject always to the condition that the enterprise as a whole has made larger profits. If the accounts of the Spanish branch are not sufficient to satisfy the Spanish administration, arbitrary measures are taken. (The method

of making a comparison with similar Spanish enterprises once raised such opposition that it will probably not be employed again.)

If the Spanish branch does not have real economic autonomy, the jury makes a special examination of the rules according to which the Spanish establishment is managed, and the method employed rests entirely on the results of that examination.

The British Board of Inland Revenue assesses the local branches of foreign banks on the basis of their separate accounts in about two-thirds of the cases. In the remaining one-third, owing to interlocking transactions between the foreign head office and the branch (*e.g.*, cross credits and debits, intricate interest adjustments, etc.), the separate accounting method cannot be followed and the United Kingdom profits are frequently determined as that proportion of the total profits as the United Kingdom assets bear to the total assets. The difficulties involved in determining which are United Kingdom assets and which are foreign assets are usually capable of adjustment after negotiation.

Under the law of the United States of America, banks are subject to the general provisions for allocation contained in Section 119, and because of the nature of the income of banking enterprises few questions arise as to the determination of the source. Difficulties are frequently encountered, however, in allocating deductions for expenditures for overhead, interest charges and the like. The apportionment of non-allocable items of expense, on the basis of gross income from sources within the United States to total gross income, is permitted by Article 680 of Regulations 74.

The American report observes that the relative freedom from difficulty in assessing banks is due to the fact that the items of income and of expense are, for the most part, readily allocable. For example, the location of the following sources of income may be easily determined: deposits, loans, discounting commercial paper, exchange and arbitrage transactions, purchasing and selling of bonds and other securities, renting office space in buildings owned or leased by the bank and renting safe deposit boxes. Similarly, most of the expenditures of a banking enterprise are readily allocable to a particular country, such as leasing of business property, repairs, interest on deposits, taxes, losses, bad debts, depreciation, and salaries and wages to officials and employees occupied with local business. Items of general overhead expenses, including the salaries of executive officials occupied with the entire business which may not definitely be allocated, may be apportioned as indicated above. Sometimes questions arise as to where bad debts and losses were incurred, and as a rule a bad debt is allocated to the place where the loan agreement was contracted.

(c) *Insurance Enterprises.*

With regard to the French tax on industrial and commercial profits, the only special regime concerns insurance companies. Such enterprises have the choice between an arbitrary evaluation of their taxable profit and the determination of their real net profit according to the rules applicable to French enterprises. Their selection may be changed each year with the result that if an enterprise has selected one year to be taxed on an arbitrary basis, it may place itself the following year under the regime of taxation according to the real net profit.

The arbitrary regime consists in determining the taxable profit by applying an appropriate coefficient to the amount of the premiums collected by the foreign enterprise in France, Algeria, the French colonies and protectorates or corresponding to the risks situated in these territories. For each enterprise, this coefficient is equal to the proportion between the taxable profit and the amount of premiums of the five most prosperous French enterprises insuring the same kinds of risks or carrying out the same business.

When the tax is imposed on the real income of the enterprise, this income is determined by adding together the net business profit realised in the French territory described above, and the net income from real or personal property guaranteeing the operations effected in this territory.

For the purpose of fixing the taxable quota for the French tax on income from securities, the administration computes the value of the French assets in the following manner: In the first place, it endeavours to ascertain the comparative value of the French agencies and of all agencies of the company, and if there are no precise indications in the balance-sheets, this value is treated as being equivalent to the proportion existing between the French premiums (*i.e.*, the premiums payable in France by virtue of contracts concluded there) and the total premiums. As, however, the collection of premiums forms only the business income of the company, and as the distribution of profits made by the company includes also income from the investment of funds constituting reserves, one ascertains the proportion which the business profit bears to the total profit. This double operation is represented by the following proportion:

$$\frac{\text{French premiums} \times \text{business profits}}{\text{Total premiums} \times \text{total profits}}$$

Frequently, foreign insurance companies operating in France own French securities and real property—for example, life insurance companies which are required by French law to guarantee their contracts in France by reserves consisting partially in French movable or immovable property. The relative value of these assets is determined by comparing, according to the figures of the balance-sheet, the amount of French investments with the value of the entire capital assets. One then considers the share that these investments have contributed to the non-business profit, which is equal to the total profit diminished by the business profit. The fraction thus obtained is added to that which represents the comparative value of the French agencies, and it is the reduction of these two fractions into a single fraction which determines the taxable quota.

The following example of this procedure is given in the French report: Suppose a foreign insurance company has collected French premiums valued at 5 in a total of 100, and for which the business profit is 2 in a total profit of 4, the comparative value of the French agencies is:

$$\frac{5 \times 2}{100 \times 4} = 0.025$$

If that company possesses French property valued at 1 and total assets of 100, its non-business profit being 2 (4 — 2), the comparative value of the French assets is:

$$\frac{1 \times 2}{100 \times 4} = 0.005$$

Its taxable quota is therefore $\frac{3}{100}$. 0.030

The German report states that where it is necessary to resort to apportionment in taxing insurance enterprises, the administration takes either the ratio of gross receipts realised in Germany to total gross receipts or the ratio of premium income in Germany to total premium income.

In Great Britain, although the local establishment of a fire insurance company is normally assessed on the basis of separate accounts, the local establishment of a foreign life insurance company is normally charged on such a proportion of the company's total income from the investments of its life insurance fund as the United Kingdom premiums bear to the total premiums received by the company, less a corresponding proportion of the total management expenses of the company. The term "United Kingdom premiums" includes those received from United Kingdom policy-holders and also from foreign policy-holders whose proposals were made at or through the United Kingdom establishment.

The Spanish jury, in cases where no treaty is applicable, makes very close evaluations in taxing insurance companies. In fixing the proportion of premiums, one attributes to the different branches of insurance different weights, these weights being deduced from the relation shown by the accounts between the premiums and the profits of the different branches of insurance made by the enterprise in Spain. Furthermore, one takes into account the special condition of competition or the existence of cartels or other forms of agreement between the different enterprises.

The Revenue Act of the United States of America subjects foreign mutual insurance companies other than life, except for a few special provisions, to tax in the same manner as other corporations, but provides special methods of assessment for foreign life insurance companies and for insurance companies other than life or mutual (Revenue Act of 1928, Sections 201 to 208).

The taxable net income of a foreign life insurance company is determined by means of an apportionment fraction, as follows: The amount of its net income for any taxable year from sources within the United States is the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted (Revenue Act of 1928, Section 203 (c)). The practicability of this formula has seldom been tested, as there are very few foreign life insurance companies operating in the United States.

In the case of insurance companies other than life or mutual, which category includes fire and marine insurance companies, the United States branch is for the most part an autonomous unit, the supervision of the foreign home office being merely nominal. A special income tax is imposed on these companies and only income from United States sources is stated in the return. Questions of allocation therefore arise only in connection with the deduction of a rateable part of the head office expenses and foreign taxes on income from United States sources.

(d) *Railroad, Motor-bus and Other Transport Enterprises.*

For the purposes of the French tax on income from securities, the taxable quota of railroad companies, which are concessionaires of a system or a part of a system, is obtained by comparing their French receipts with their total receipts. The French receipts include only the price of transport received in France; nevertheless, if a company is unimportant and its system is composed of lines situated at the same time in France and abroad, one counts as French receipts the price of transport applicable to the carriage in France, regardless of where the price was collected. For other transport companies, including ticket agencies, the taxable quota is determined by taking the average of the three proportions existing between: (1) the French assets and the total assets; (2) remuneration paid to employees in France and that paid to the entire personnel; (3) the amount of commissions collected in France and the total amount of commissions. With regard to air navigation companies, no cases have yet been brought before the administration, but it is probable that such enterprises would be assimilated to maritime navigation enterprises not subject to the treaty regime of reciprocal exemption. The French report indicates that it is probable, furthermore, that the administration would include, either in total receipts or in total assets, the amount of the subventions that these enterprises receive from their national Governments.

In the case of maritime navigation companies which are not subject to the treaty regime of reciprocal exemption, one ascertains in fixing the taxable quota the number and tonnage of the boats embarking or disembarking passengers or loading or discharging merchandise in France. A comparison of these figures permits the determination of the amount of the material used in the French business. The result of this calculation is controlled by the comparison

of the amount of the freight and passenger money received in France and the total receipts of the enterprise.

Where the German administration finds it necessary to resort to an apportionment in the case of transport enterprises, it frequently takes the ratio of salaries and wages paid in Germany to total salaries and wages paid, excluding any directors' percentages (*Tantiemem*) paid out of profits. Germany has concluded agreements for the reciprocal exemption of shipping profits with a large number of countries.

Because of its island situation, the questions concerning the allocation of profits of transport enterprises arise in Great Britain only in connection with maritime and air navigation enterprises. Great Britain has concluded agreements for the reciprocal exemption of maritime navigation profits, but, in the case of one or two steam shipping companies, the United Kingdom profits have been determined to be the same proportion of the total profits as the United Kingdom receipts bear to the total receipts. A similar basis has been adopted provisionally in the case of an air line.

In Spain foreign maritime navigation companies are not taxable unless they have establishments there. In this case Spain follows the method of determining the relative importance of receipts for transportation in Spain. This result has sometimes been modified to take into account a difference in Spanish tariffs which is due to difficulties in securing an increase in rates in Spain.

The United States Revenue Act provides a formula for the allocation of transport or other services rendered between the United States and other countries, but this formula is seldom if ever invoked in the case of railroad or motor-bus companies. In practically every case, foreign railroad companies operating in the United States do so through subsidiary companies, with the result that their income is determined separately in accordance with the books of the company. Moreover, a very satisfactory check on the gross income and expenditure allocable to the United States is afforded in the statement that must be submitted annually by every railroad operating in the United States to the Interstate Commerce Commission, which prescribes the manner in which accounts are to be kept, determines rates, and requires a statement of the portion of through-tariff rates which is allocable to the United States. Where it is necessary to apportion through rates, the mileage factor is given due consideration.

In the case of a railroad connecting Canada and the United States through a tunnel, a few small items are entirely allocated to the country to which they can be definitely assigned, but substantially all the income is apportioned at the rate of 50 per cent to each country. The same method is followed in the case of a bridge connecting the two countries at Niagara Falls.

Although few cases involving motor-bus companies have yet arisen, it is to be expected that revenue and expenses would be divided on a mileage basis.

In the case of maritime shipping companies, the problem of allocation has been almost eliminated because practically all important foreign countries have entered into arrangements for reciprocal exemption of shipping profits under Sections 212 (b) and 231 (b) of the 1928 Act or equivalent provisions of prior Acts, with the result that practically no large foreign shipping company operating in United States waters pays the federal income tax. In cases where the reciprocal exemption provisions do not apply, Article 683 of Regulation 74 contains a complicated apportionment fraction, which takes into account the ratio between the sum of the costs or expenses of such transportation business carried on within the United States and a reasonable return on the property used in its transportation business within the United States, and the sum of the total costs or expenses of such transportation business and a reasonable return upon the total property used in such business. Nevertheless, the taxpayer may apply for permission to base his return upon his books of account if they have been properly and regularly kept and show a detailed allocation of receipts and expenditure which reflect the income more clearly than the preceding method.

(e) Power, Light and Gas Enterprises.

There have been no cases of such companies in Great Britain or the United States of America operating internationally, but if such a case existed in the United States, the income would be regarded as arising from sources partly within and partly without its territory under Section 119 (e).

The French report states that, in so far as the fixation of the taxable quota on the tax on income from securities is concerned, the quota would be determined by comparison with the value of the plants and other assets in France and the total value of the property of the enterprise. The Spanish report states that the method of fractional apportionment most frequently employed is that based upon assets, taking into account the active and passive credits of the exploitation. This first calculation is then modified to take into account the rates charged and the price of coal in Spain. In some cases, another correction has been made to account for the appreciable differences in the relative frequency of the services. When this computation has been made, one compares it with the results of the accounts. If there is no considerable difference, then the profit as determined by the accounts is followed, but it frequently arises that the discrepancies are very considerable, because of the prices charged for coal and other raw materials to the Spanish establishments. In such a case, the result of the previously described computation is employed for fixing the relative percentage adopted by the jury.

(f) Telegraph, Telephone and Radio Enterprises.

As the French telegraph and telephone systems are established on French territory and belong to a State monopoly, no question of allocation has arisen except in the case of companies which are owners of submarine cables. For such companies, the taxable quota has been established on the basis of the ratio between French transactions and total transactions—that is to say, between the product of the French traffic and the total product of telegrams sent by the various stations included in the system of the company. Similarly in Spain, the telephone services are monopolised by the State.

With regard to the British tax, in one case the United Kingdom profits have been taken to be such a proportion of the total profits as the United Kingdom receipts bear to the total receipts. In another case, the United Kingdom profits have been based on United Kingdom receipts, less expenses relating exclusively to the United Kingdom and also a proportion of the overhead expenses (*i.e.*, those not relating exclusively to a particular country), the United Kingdom part being computed on a "user" basis (the term "user" meaning the number of words sent out).

An enterprise of this kind operating within and without the United States would be taxable under Section 119 (e) of the Revenue Act of 1928, which concerns income from sources partly within and partly without the United States.

(g) Mining Enterprises.

Where a company is concessionaire of a mine in France, the taxable proportion is determined by comparing the tonnage extracted from the concession in France with the total tonnage extracted by the company. If the mine is not exploited, the comparison is established in accordance with the value of the mine and the total assets of the company, the value of the mine being obtained by evaluating the amount of ore contained in the mine and applying to the number of tons thus estimated the cost price or the estimated value of each ton.

The Spanish practice envisages three cases: (a) purely mining companies; (b) enterprises exploiting mines and transforming the ore in Spain or elsewhere; and (c) enterprises in which mining plays only a secondary or complementary rôle in the entire business.

With regard to purely mining companies, they usually operate exclusively in Spain except for the centre of management abroad. The problem of allocation is therefore reduced to the determination of the importance of the direction of the enterprise. In most of these cases, the market for the minerals has been organised for a long time and the management has practically no important problems to solve. In general, the jury assigns about 10 per cent of the profits to the centre of management and 90 per cent to Spain. This figure is the result of experience gained in a number of cases.

Where an enterprise both mines and transforms minerals in Spain and abroad, the jury may attempt to ascertain the relative importance of the two departments. If it is impracticable to make this separation, one employs as a basis the amount of the capital engaged in each department. Very frequently one considers the result of this method as only a first estimate, subject to subsequent modifications if there are special circumstances such as differences in the risk incurred by the capital.

Income from securities held by these companies are always assigned to the centre of management abroad. Another general rule in the Spanish practice is that minerals held in warehouses which are almost always situated in Spain are excluded from the computation. The reason is that the enterprise can very well store these minerals outside of Spain if the difference in the amount of the tax would make it worth while. The Spanish practice is guided by the principle that unless the law imposes another solution, the tax must not interfere with the most economic conduct of the enterprise.

It is also important to note that the part of the assets represented by the mineral deposits is not taken from the accounts of the company but is the object of a special evaluation by the mining experts of the Government. The experts of mining companies have frequently suggested to the jury that it employ the method based on the difference between the value of the deposits and the cost of production, but this method has been rejected because of the very large differences resulting from the variations in quality. The control of the quality by the administration is practically impossible because of the variation in quality in the same deposits.

Where mining plays only a secondary part in the entire business of an enterprise, the jury makes the separation of profits by the ordinary methods, and if the profits of mining in Spain are absorbed by the losses of the other kinds of business in Spain, the enterprise is not taxable on such profits.

Mining and extractive industries are subject to the rules governing the production of personal property within the United States and its sale without, or *vice versa* (Revenue Act of 1928, Section 119; Regulation 74, Article 682). The part of the income usually allocable to the country of production is, therefore, that determined by the independent production price. If no such price can be determined, the part of the net income which is allocable to the United States is determined by apportionment on the basis of property and gross sales. The taxpayer may apply for permission to base his return upon his regularly employed books of account when they show a detailed allocation of receipts and expenditure which reflects more clearly than the preceding method the income derived from sources within the United States. A rateable part of any expenses, such as general overhead, which cannot definitely be allocated to some class of gross income, may be deducted from gross income from sources within the United States.

Certain oil companies extracting oil in one country, refining it in a second and selling it in the United States have been able to segregate the profits of each stage of the business as there is a market price prevailing for the production at each stage. In the case of ore-mining companies, however, the same enterprise usually handles all the stages from mining the ore and smelting it to the sale of the finished products, and it has been found difficult to determine a fair market price for the product at each stage. It has been proposed as a general rule that, if the product has an established market value in the country in which it is produced, such value should be considered to represent gross income in such country. The difference between that

value and the price at which the finished product is sold in another country should be considered as gross income to be allocated to such country.

In general, transportation, insurance, selling costs and overhead would be the main deductions allowable against this gross income in arriving at the net income taxable in the country of sale.

III. LAW AND PRACTICE OF EACH COUNTRY WITH REGARD TO NATIONAL ENTERPRISES.

In general, not many difficult questions of allocation arise in the case of national enterprises carrying on business through subsidiaries or permanent establishments in other countries. This is due to the fact that France, for the purpose of the tax on income from securities, and also Germany, Great Britain, Spain and the United States of America, for the purposes of the income tax, subject a national enterprise to liability on the whole of its profits even though derived from foreign sources. Certain derogations have been made from this rule in order to prevent double taxation, which will be described below.

The criterion for determining what is a national enterprise varies widely. Under French law the most generally accepted principle is that an enterprise is French if it has its statutory seat (*siège social*) in France. German law subjects a company to full liability if it has its seat or real centre of management in Germany. A company is subject to full liability to the tax of the United Kingdom if it has therein its place of management and control. A company is fully liable to the Spanish tax if it is organised in accordance with Spanish law and has its legal domicile in Spain. The United States of America imposes full liability on companies organised in the United States.

Where the enterprise belongs to individuals operating singly or in partnership, Germany and Great Britain subject the individuals to full liability if they are resident in their respective territories, and the United States if the individuals are citizens or residents of that country. Under Spanish law, the enterprise belonging to an individual or partnership composed of individuals domiciled in Spain is, in principle, liable to tax on only that part of its profits which is derived in Spain. The French individual *entrepreneur* or partner domiciled in France is subject to the French general income tax on the whole of his profits, but is liable also to the tax on industrial and commercial profits in accordance with the same principles as companies. This tax is levied in conformity with the principle of territoriality—that is to say, only profits derived directly by an establishment in France are liable thereto. Consequently, if an enterprise has an establishment in France which makes sales in another country where the enterprise has no permanent establishment, the profit from these sales is ascribed to the French establishment. On the other hand, if the enterprise has an establishment in another country as well as in France, the income derived by the activities of the foreign establishment is ascribed to it. If, therefore, an enterprise manufactures at an establishment in France and sells at an establishment in another country, the French Government imposes a tax only on the profits attributable to the activities of the French establishment and an allocation of profits must be made. Where the accounting of the French establishment does not reveal this profit, the empirical methods previously described may be resorted to.

In order to reduce or prevent double taxation of national enterprises, each of the five countries has adopted certain measures, either by legislation or by treaty. The previously described principles for imposing only profits attributable to a local permanent establishment precludes double taxation under the commercial and industrial profits tax. Where a French enterprise has a foreign subsidiary company, France exempts from the tax on income from

securities that portion of the dividends distributed by the French parent company out of dividends and interest received from the foreign subsidiary and subjected to the French tax on income from securities when received by the French parent company, provided various conditions are fulfilled (Law of July 31st, 1920, Article 27 and Law of July 31st, 1929, Article 4).

Germany has concluded a number of treaties with European countries in which it is provided that each contracting State shall tax only the profits of an enterprise which are allocable to an establishment within its territory. Consequently questions of allocation or apportionment arise which are solved according to the circumstances of each case by the competent officials.

Where a British enterprise derives income from a dominion and is subjected to tax there, it may claim relief against the United Kingdom income tax on that part of its income calculated at the lower of the two following rates—*viz.*, (a) the dominion rate of tax, or (b) one-half of the rate of United Kingdom tax applicable to the enterprise.

In accordance with the principle of economic unity, Spain subjects Spanish enterprises to tax on the whole of their profits, including those derived abroad from branches or subsidiary companies. If the foreign profits have been subjected to tax abroad, however, they are not taxed again in Spain, subject to the minimum requirement that the Spanish enterprise shall be taxed on at least one-third of its profits, as a charge incident to nationality. Similarly, if the Spanish company distributes dividends or pays interest, only that proportion of such income is taxable which is derived from activities in Spain, subject to the limitation that at least one-third of the total amount distributed as dividends is liable to taxation (Decree Law of June 30th, 1925).

The United States of America grants against its tax, on the total income of domestic companies or citizens, a credit in respect of taxes paid abroad on foreign income which, broadly speaking, is equal to the foreign tax on the foreign income, or to the United States tax thereon, whichever amount is the lower (Revenue Act of 1928, Section 131).

ALLOCATION OF PROFIT TO THE REAL CENTRE OF MANAGEMENT WITHIN THE COUNTRY.

If an enterprise has only its seat (*siège*) in France and carries on all its activities at establishments situated abroad, the tax on industrial and commercial profits is not payable. If, however, dividends and interest are paid by the seat in France they would be liable to the tax on income from securities, even though paid out of income derived from the foreign establishments. In Germany and the United Kingdom, the fact that the real centre of management is situated in either country would entail full liability to tax, even though all the productive operations were carried out in other countries.

The Spanish report declares that if the enterprise in question is Spanish, it would be subjected to tax in Spain on at least one-third of its profits. On the other hand, if the enterprise is foreign, it would not be subject to this minimum tax even though its real centre of management were in Spain, but one would determine the profits allocable to the real centre of management in Spain according to the same rules that have been described in the case of a foreign company that has its centre of management abroad, but with a branch in Spain.

Under the United States Revenue Act, if the corporation is organised in the United States, no profits are ascribed to the real centre of management as such, but it will report all its income from all sources on its income tax return. If no other function but management is performed in the United States, and if no sales are made there of the product manufactured abroad the income would all be ascribed to foreign sources so far as that income is concerned. Other items would similarly be allocated to their country of source. There would be a domestic tax liability in these circumstances, even though the income were 100 per cent foreign, but this tax liability might be extinguished by credits that can be taken against it in respect of taxes paid abroad on the foreign income.

IV. HOLDING COMPANIES.

I. NATIONAL COMPANIES CONTROLLING FOREIGN SUBSIDIARIES.

In general, it may be said that a holding company organised under the law of any one of the five countries covered by this report is subject to tax on the dividends and interest received from foreign subsidiaries, except for certain measures that have been taken to prevent double taxation.

France excludes from the tax on industrial and commercial profits interest and dividends which have been subjected to the French tax on income from securities, thus preventing internal but not international double taxation. This deduction includes a proportionate part of the expenses allocable to such income. As has been previously mentioned, a French company which acquires at the time of issue shares or bonds of foreign subsidiaries, and pays the French tax on dividends or interest received therefrom, is not required to pay the tax again on dividends distributed out of the amounts so received in the same fiscal year, provided such registered shares or bonds have remained inscribed in the name of the French company (Law of July 31st, 1920, Article 27 ; and Law of July 31st, 1927, Article 4).

Where a French company purchases the shares of foreign companies on a stock exchange or acquires them otherwise than under the conditions mentioned above, the French tax on income from securities is payable both at the time when the French company receives such income and also at the time when it redistributes it.

When a German company receives income from foreign companies it is subject to the German tax, but if the German company and a foreign company form an economic unit, the total profits of the foreign company may also be assessed to German tax. These general rules have been subjected to certain restrictions in double-taxation treaties.

A British holding company would normally be assessable only in respect of its net profits including dividends and interest received from foreign subsidiaries, but, in exceptional cases, where the foreign subsidiary company was a mere simulacrum or an agent of the holding company, the latter might be assessable on the total profits, including those of the subsidiary.

If a Spanish company has under its control one or more foreign subsidiary companies operating abroad, the Spanish company is considered as carrying on this business itself. If the Spanish company is a purely holding company or investment trust, it is liable to tax on all its income inclusive of dividends and interest from foreign securities, and no deduction is allowed for the foreign dividend and interest income as is granted in the case of a Spanish company deriving profits from trading abroad.

A holding company organised in the United States of America is subject to the ordinary rule of liability in respect of all its dividends, interest and other income from holdings in foreign companies, subject, however, to the credit for foreign taxes previously described.

2. LOCAL SUBSIDIARY CONTROLLED BY A FOREIGN COMPANY.

This question has been answered for the most part in dealing with local subsidiaries of foreign companies. The dividends or interest paid by the local subsidiary to the foreign company are subject to the source tax on dividends and interest imposed by France and Spain, and to the recoupment of the standard rate when the subsidiary company is in Great Britain. Similarly, the source tax would be withheld from dividends paid by a German subsidiary, and from the interest paid by an American subsidiary to the foreign holding company.

Moreover, there are certain circumstances under the laws of France, Germany, Spain and the United Kingdom, in which a foreign company controlling a local subsidiary company may be brought into the jurisdiction of the taxing State. For the purposes of the French tax on income from securities, a foreign company may be subjected to this tax on the taxable quota

of the dividends and interests which it pays abroad when it controls a French company with similar objects. Various French courts have given as indicia of control the ownership of a majority of the registered stock in the French company and having a majority on the board of directors of the French company.

The German law subjects a foreign corporation to liability if it forms an economic unit with a German company, but, in order to do this, it is usually necessary for the fiscal authorities to establish that the German company is an organ or a *de facto* branch of the foreign company, and, so far, there have been very few cases in which foreign companies have been taxed on this basis.

The economic unit theory dominates the Spanish system, but, as has been previously indicated, before a Spanish company can be taxed as a part of the foreign enterprise, a declaration must be issued stating that the Spanish company is in one of the four situations of dependency previously described.

The British law provides in substance that, where a foreign holding company is also a trading company and relations between the subsidiary company and the holding company are such that the accounts of the subsidiary do not show the true profits, the foreign company may be charged through the subsidiary company as agent on the true profits (Income Tax Act 1918, General Rule 7).

If the United States authorities have reason to believe that profits are being diverted from an American subsidiary to a foreign parent, they may redistribute the income of the two companies so as to prevent evasion (Revenue Act of 1928, Section 45).

V. DIFFICULTIES EXPERIENCED BY ADMINISTRATIONS.

The French report makes the observation that no difficulties of any importance have been experienced in connection with the tax on industrial and commercial profits, which is levied on the basis of separate accounting. On the other hand, the report declares that some difficulties have arisen in connection with the imposition of the tax on income from securities on foreign companies possessing or exploiting property in France. The report summarises the principal criticisms which have been raised against the French tax on income from securities as follows :

1. The fact that it is superimposed upon the tax on industrial and commercial profits.
2. The incidence of the tax falls in effect on foreign shareholders and bondholders who otherwise would be outside French fiscal jurisdiction.
3. The taxable quota, being calculated with reference to the assets of the French business, never takes account of the profits realised in France.
4. The French system creates a double Tax in the case of foreign companies controlling subsidiaries in France, as, in this case, the foreign company bears the tax on dividends which they receive from their subsidiary and must pay again the same tax without deduction of the sums already paid, because of the source of the income which they possess in France.

The report says that certain arguments, which are summarised below, can be presented to justify the present regime :

(1) Being applied in addition to the tax on income from industrial and commercial profits, the tax on income from securities does constitute a superimposed tax. It is based on the fiction of French legislation that a company possesses a juridical personality distinct from that of its shareholders, and consequently these two taxes are deemed to reach two different taxpayers—(1) the company, because of the profits which it realises, and (2) the shareholders by reason of the enrichment they derive from the distribution of profits. The report observes that this fiction is evidently contrary to reality, because, in fact, a company only manages or renders

productive, for the account of its shareholders, the capital which the latter have placed in it. Nevertheless, foreign companies should not object inasmuch as French companies are subject to both taxes.

(2) It is not exact to maintain that, in collecting a tax on profits distributed to foreign shareholders and bondholders, the French law does not take into account the fact that the taxpayers are abroad. All direct or indirect taxes paid in France by a company reduce *pro tanto* the profits which may be distributed by the company, and consequently all these taxes are indirectly borne by the shareholders in the same manner as the tax on income from securities.

(3) The report observes that the criticisms directed against the taxable quota appear much more founded. The reason for the tax being the realisation of profits on French territory, the tax on income from securities should logically cease to be due when no profit is derived in France, and should be due only to the extent of the profit derived from French territory. But the French law, continues the report, has very wisely given to this tax an arbitrary character (*caractère forfaitaire*) in presuming that there has been realised in France the same fraction of distributed profits as the profits or business in France bear to the total profits or business.

The report observes that the present study carried on by the Fiscal Committee of the League of Nations with regard to the allocation of profits reveals the difficulty in determining exactly the part of the profits that an enterprise realises on the territory of each of the states in which it has an establishment. At present, each establishment, each branch, each subsidiary company do not constitute autonomous exploitations having their own interests and with profits which are destined to be added mathematically together; they appear rather to be joint members of a single organisation and to have the purpose of co-operating in various ways to realise a joint profit. It is not possible to say that one establishment has procured a certain profit because that establishment may only serve to suppress a dangerous competition for the establishment situated in another country. In this case, the accounts of the establishment will most frequently show a deficit whereas in reality it will have contributed to increasing the turnover of the other establishments, and consequently, the general profit.

The French report also asks how are the profits to be determined when for fiscal or economic reasons an establishment installed in a State is voluntarily rendered unproductive. A company may impose upon one of its foreign establishments either an increase in the price of goods which the company ships to it or a diminution in the sales price which the establishment makes to the home office or to one of the branches or subsidiaries situated in a third country. The establishment will thus be made unproductive, but the profit of which it has been deprived will appear in the accounts of the home office or of the other branches or subsidiaries.

In view of these facts, the report asks what solution may be proposed other than the present one, although it has the inconveniences of an arbitrary method. It is true that the taxable quota is in contradiction with the very nature of the tax on income from securities as it gives to that tax, which should essentially reach income, a basis of assessment appropriate to a tax on capital. Nevertheless, this method of assessment, according to the report, has a double advantage: in the first place, it enables the Treasury to prevent any combination tending to conceal profits derived in France or to transfer them to another country, and to tax foreign companies controlling French subsidiaries; in the second place it saves foreign companies from all controversy with the French fiscal authorities on the subject of the determination of taxable profits and imposes on them only the obligation of declaring their turnover, the results of their balance-sheets and the deposit of the Minutes of their general meetings of shareholders.

(4) The French report concludes its arguments with the admission that there is no decisive argument to justify the double liability of foreign companies with French subsidiaries, and that it is difficult to understand why profits derived by foreign companies in the form of

dividends from their French subsidiaries should be successively taxed at the moment when received and subsequently at the time of their distribution. In this respect, the French Government has always declared itself disposed to amend its legislation, but it does not intend to consent to such modifications except in favour of taxpayers belonging to countries which would themselves agree to modify their national legislation as to abolish similar practices.

The British report states that owing to the principles underlying the United Kingdom tax (primarily separate accounting) no difficulties between the United Kingdom authorities with those of other countries have arisen.

The American report lists the following difficulties :

1. Difficulties arise where a diversion of profits from one country to another is suspected and where at the same time it would appear advisable, under the circumstances, to inspect the home office books in order to determine world income and world invested capital in case such items are factors in a check on reasonable profits. They are also encountered where an inspection of the books of accounts of the home office might indicate adjustments to branch books permitting determination of branch income on such revised book basis rather than on an artificial or empirical basis. These difficulties include questions of political expediency, or practical obstacles presented by (a) the distance necessary to be travelled, (b) the interpretation of the foreign language, and (c) an understanding of the foreign methods of keeping books.

2. Other difficulties are those of checking costs plus reasonable profits, reflected in invoices, on goods delivered by a home office in one country to its branch in another or by a foreign company to its domestic subsidiary company ; or, on the other hand, of establishing an independent factory price for the goods up to the time they are received by the branch or the subsidiary company, reflecting a reasonable profit on the raw materials and all processes added thereto up to the time of delivery to the branch or subsidiary company. Such independent factory price should be based as far as possible on known markets, established by independent arm's-length transactions.

3. In cases of national enterprises doing business in foreign countries whose taxes under domestic assessment are credited with taxes paid to such foreign countries, it is often difficult to obtain copies of receipts, assessment notices or other forms of statement from the foreign governments, evidencing the fact that the tax claimed has been paid or is a liability, the nature of the tax and the accrual of income with respect to which it has been paid.

4. Sometimes difficulties arise because of the difference in allowances under the laws of the United States of America and foreign countries in respect of expenses, bad debts, losses, depreciation and depletion.

VI. RECOMMENDATIONS TO THE FISCAL COMMITTEE.

The French report concludes with a recommendation that, after having adopted a common definition of " establishment ", the principal States should agree that each tax only the profits realised by establishments exploited on its territory and adopt common rules for allocating the profits realised by enterprises having several establishments in different States. The measures thus drafted could, in conformity with the views of the League of Nations, be made the object of bilateral or multilateral agreements.

The German report observes that the method of separate assessment, wherever it is possible, gives correct results and is easy to apply, but the report points out that if the authorities of one State make adjustments which are not recognised by another State which is affected, double taxation may arise. Empirical methods (for example, comparative assessments, normal rate

of interest, average rates) offer the simplest solution from the viewpoint of the authorities, but are sometimes unfair because they ignore the effect of circumstances peculiar to the foreign enterprise. As the method of fractional apportionment has certain advantages, both from the viewpoint of fairness and of preventing double taxation, the ideal and therefore perhaps unattainable goal would be to determine the total profits of the entire enterprise on a uniform law and divide the total profits on agreed principles. Although this system might be employed within an individual State in regard to the division of the tax revenue between the various interested political subdivisions, it is not possible in international intercourse to have a uniform determination of total profits, in view of the fact that there is no harmony between the tax legislation of the various countries. The report suggests that an agreement regarding the principles of allocation would be essential, and that they would probably have to be different for the various classes of enterprise. Experience might lead to establishing certain agreed allocation fractions. The experience of the German administration has been that in relations with States, whether or not parties to double taxation agreements, sometimes one method and sometimes another has been suitable; these depending upon the circumstances of the particular case.

The Spanish report closes with a number of recommendations on behalf of the system employed in that country which are summarised below:

1. The Spanish system of allocating profits does not form a part of the ordinary procedure in assessment, but is, in itself, a juridical act distinct from the procedure of the assessing authorities. The jury is composed of men free from fiscal zeal. Furthermore, it must give a hearing to the taxpayer. It must take the opinion of appropriate industrial and commercial representatives. It guards with absolute secrecy the information it has obtained from examining documents pertaining to the taxpayer's business. The Spanish method is excellent, states the report, because it follows the practice of business men and avoids the atmosphere and spirit of tax administrations.

2. Although it is hard to believe that a general solution of the problem of allocation may assure the taxation of not more than 100 per cent of the profits, the Spanish report states that the Spanish system satisfies this test and is constructed on its basis. Although the system of the economic unity is developed to the last degree with regard to Spanish companies, it is surrounded by a series of very efficacious guarantees in the case of foreign companies with subsidiaries in Spain—*i.e.*, the conditions under which the administration may declare the existence of an economic unity are precisely enunciated by the law and the tax may not be imposed until the declaration has been accepted or confirmed. Nevertheless, the limitations in the application of the principle of the economic unity present very difficult problems in connection with the evaluation of patent royalties, service and other charges paid by the subsidiary to the parent. No rule has yet been developed for these problems.

The recommendations contained in the American report are as follows:

1. Inasmuch as in all cases of the assignment of income to a particular country, whether the enterprise produces or processes in one country and sells in another or purchases in one country and sells in another, the place of sale is a factor recognised as of the utmost importance in any computation of distribution to different sources, it follows that agreement as to what determines the place of sale, for purpose of tax assessments; would eliminate differences of procedure and double taxation in so far as this factor is concerned.

2. In the case of goods being purchased in one country and sold in another, double taxation of this particular item of income would be prevented if all countries agreed that the profit of the entire transaction arises solely in the country of sale and should therefore be subject only to its tax.

3. Where the principle is followed that income derived from the purchase and sale of goods should be taxable only in the country of sale, it is recommended that the goods purchased in the one country be invoiced to the selling establishment in the other country at the cost price.

4. Where double taxation is avoided by a credit for foreign taxes, an agreement should be reached as to what class of taxes shall be allowed as a credit—*i.e.*, (a) like taxes or (b) all income taxes under Federal Law, whether or not for use and benefit in part of territorial subdivisions; or (c) income taxes under territorial subdivision law, for benefit of such subdivisions.

5. In order to facilitate the securing of relief against double taxation which is granted under section 131 to United States citizens and corporations, and resident aliens, it would be helpful if other countries, when imposing taxes on such taxpayers, would indicate on the receipt given for the tax paid the name of the taxpayer, the name, rate and date of the tax, the source and amount of income, and the year of accrual of the income.

TAX SYSTEM AND ALLOCATION METHODS IN FRANCE

BY

JEAN GUILLET,

Sous-Chef,

Direction générale de l'Enregistrement, Ministère des Finances,

AND

ROGER PIERRE,

Sous-Chef

Direction générale des Contributions directes,
Ministère des Finances.

PART I. — BRIEF SURVEY OF FRENCH LEGISLATION REGARDING SCHEDULAR TAXES ON INCOME.

The taxes levied in France on the various classes of income are the following :

1. Tax on income from buildings (*la contribution foncière des propriétés bâties*) ;
2. Tax on income from lands (*la contribution foncière des propriétés non bâties*) ;
3. Tax on income from movable capital (*l'impôt sur le revenu des capitaux mobiliers*) ;
4. Proportional charge on mines (*la redevance proportionnelle des mines*) ;
5. Tax on industrial and commercial profits (*l'impôt sur les bénéfices industriels et commerciaux*) ;
6. Tax on agricultural profits (*l'impôt sur les bénéfices de l'exploitation agricole*) ;
7. Tax on salaries, wages, pensions and annuities (*l'impôt sur les traitements, salaires, pensions¹ et rentes viagères*) ;
8. Tax on profits from non-commercial occupations (*l'impôt sur les bénéfices des professions non commerciales*).¹

The following is a brief statement of the rules for the assessment of each of these taxes.

1 and 2. TAX ON BUILDINGS AND LANDS.

(Law of 3 Frimaire, Year VII ; Law of August 8th, 1890 ; Law of March 29th, 1914, Articles 1 to 30 ; Law of April 1st, 1926, Article 31 ; Law of August 3rd, 1926, Article 23 ; Law of April 26th, 1930, Article 1.)

The land tax is intended to be levied on the income from real property, whether buildings or lands, *which is situated in France*.²

Accordingly, persons domiciled in France and enterprises having their head office there are not liable in respect of real property owned by them abroad.

On the other hand, the tax is payable by persons domiciled abroad and enterprises having their head office abroad if they own real property in France.

The taxable income derived from real property is assessed by the tax Administration.

In the case of buildings, the assessment is based on the information given in the lease. If the property is not leased, the income is calculated on the basis of the income derived from

¹ In addition to the various taxes enumerated above, there is the general income tax, which is levied upon the *total income* of the taxpayer. This tax, which is essentially personal, and is imposed only on individuals and not on companies or corporations, is payable by all persons *habitually resident in France*, irrespective of their nationality.

² Except in the special case of insurance and re-insurance companies (see below, page 67), the word "France" means the mother country, excluding Algeria and the French colonies and protectorates.

buildings of the same kind and the same size which are leased. If neither of these two methods of assessment is applicable, the taxable income is determined directly on the basis of a suitable rate of interest on the market value of the property.

In the case of lands, the taxable income is assessed according to a tariff based on the kind of crop and its class, every kind of crop being divisible into several classes, according to the fertility of the soil.

The assessments thus made are, in principle, reviewed every ten years in the case of buildings, and every twenty years in the case of lands. During the interval between revisions they remain unchanged.

3. TAX ON INCOME FROM MOVABLE CAPITAL.

The tax on income from movable capital comprises the tax on income from securities (*valeurs mobilières*) and the tax on income from loans, deposits and cash-security (*créances, dépôts et cautionnements*).

These two taxes differ, not only as regards the income on which they are levied, but also as regards the fiscal obligations they involve for those who pay that income.

The tax on income from transferable securities is imposed on :

- (1) Income from capital invested in companies in the form of shares or other holdings ;
- (2) Income from capital loaned to companies and public corporations ;
- (3) The emoluments of directors of companies with share capital.

As a general rule, this tax is deducted at the source ; companies and corporations must pay it in advance and recover from the recipients of the income.

The tax on income from debts, deposits and cash-security is leviable upon all income from movable capital which is not liable to the tax on income from transferable securities—viz., debts other than those represented by loans to companies and public corporations, deposits and security in cash. It is not deducted at the source, but must be paid personally by the recipient of the income.

A. TAX ON INCOME FROM SECURITIES.

The tax on income from transferable securities or stocks and bonds is leviable upon income from capital contributed or lent to corporations designated as such by French law, not on the basis of the nationality of such corporations, but purely in consideration of their status.

As regards contributed capital, the tax is leviable on the income, and any yield which may be assimilated to income, from :

- (1) Shares and beneficiary shares (*parts bénéficiaires*), in companies with share capital (*sociétés anonymes* and *sociétés en commandite par actions*) (Laws of June 29th, 1872, Article 1, and March 29th, 1914, Article 31) ;
- (2) Shares of limited partners in ordinary limited partnerships (*sociétés en commandite*) (same laws) ;
- (3) Partner's shares in non-commercial (*civiles*) companies, and similar shares belonging to managing associates in limited liability companies of the type referred to in the French Law of March 7th, 1925 (Article 42).

The yield from all such shares is regarded as income from movable capital. On the other hand, the yield from the holdings of partners in ordinary partnerships or of general partners

in limited partnerships, whether or not with share capital (*sociétés en commandite simple ou par actions*), and shares held by managing associates in limited liability companies constituted under French law, have the combined character of income from work and from capital, and are accordingly exempt from the tax on income from transferable securities (Laws of December 1st, 1875, Article 1, and March 7th, 1925, Article 42).

Similarly, in the case of income from capital lent represented by negotiable bonds or other instruments, or without the issue of negotiable securities¹ income tax is payable only on the basis of the borrower's status. It is applicable only to the interest or other income from loans made either to legal entities designated by French law, including provinces, departments, municipalities, communes, public institutions, etc., and companies of which the dividend-income is liable to the tax (companies with share capital, ordinary limited partnerships, non-commercial (*civiles*) companies, limited liability companies) (Laws of June 29th, 1872, Article 1, and April 28th, 1893, Article 22).

Lastly, the shares in profits (*tantièmes*), attendance fees, and miscellaneous emoluments of company directors are also liable to the tax on income from transferable securities, but only if the companies by which they are paid are companies with share capital (Laws of July 13th, 1911, Article 12, and April 29th, 1926, Article 17).

The income tax is leviable on income from transferable securities irrespective of the nationality of the corporation which pays such income. In this respect, the fiscal law provides for absolute equality of taxation as between French corporations and foreign corporations subject to the regime of *abonnement* because of having securities which circulate in France or possessing property in France (Law of June 29th, 1872, Article 4 ; Decree of December 6th, 1872, Article 3 ; Law of March 29th, 1914, Article 31). Both kinds of corporation are liable for the tax on all the income they pay out, and can recover from their members and creditors ; and, in both cases, the tax is assessed at the same rate on the same income, and is paid in the same way.

Although, however, the law has placed French corporations and foreign corporations on exactly the same footing, the circumstances giving rise to tax-liability differ in the two cases.

I. French Securities.

As applied to income from French securities, the tax is payable on the sole ground that the corporation has its head office (*siège*) in France and consequently possesses French nationality.

No matter where the corporation actually carries on business, or what profits it draws and from what source, a company which has its head office in France is liable for tax on all the income it distributes, even if it carries on all its business outside France and derives the whole of its profit from sources abroad.

Again, it does not matter what may be the nationality of its shareholders, bondholders or directors : a company which had all its shareholders and bondholders abroad and had directors of foreign nationality would be none the less liable for tax, because its articles of association genuinely established its French nationality and fixed its seat in France.

Nor does it matter where its securities are issued or quoted or in circulation ; a French company is liable for tax on the income from all the securities it issues—even, for instance, on the interest on loans contracted abroad.

¹ This applies to loans in the form of advances or openings of credits. For example, a French company for whose account a credit is opened by a foreign company must pay in advance the tax on the interest on the funds with which it has been credited, and can then recover from the lending company.

II. Foreign Securities.

The imposition of the tax on income from foreign securities depends on two circumstances : Either the foreign corporation has issued or placed or introduced its securities in France under the regime of *abonnement*; or the corporation has acquired or is exploiting property in French territory.

Foreign Securities under the Regime of the " Abonnement "

Foreign Companies having their Securities in circulation in France. — In the first case, the ground on which the corporation is liable for tax is that its securities are in circulation in French territory, and that it has contracted in advance to pay the tax itself subject to recouping the tax, if it so wishes, from the holders of its securities. The tax is payable not on the income distributed by the corporation to all its shareholders or debenture-holders, but on a proportion corresponding to the presumed number of securities in circulation in France as compared with the number of securities issued.¹

Foreign Companies exploiting Property in France. — In the second case, the reason for the levying of the tax consists in the possession or exploitation of property in France by the foreign company. When introducing the tax on income from securities, the legislature thought it might hinder the development of French companies, and decided that the tax should be extended to foreign corporations, so that they should not be left in a privileged position as compared with French companies. It is for that reason that companies and public corporations which issue securities in France or introduce them into France are liable for this tax. It is for that reason also that foreign companies operating in French territory are liable for the same tax: such companies derive from the French property they own or exploit a profit which is subsequently distributed to their shareholders and bondholders. Hence the concept of imposing on the income from capital contributed or lent to a foreign company a tax which is primarily justified on the ground that the company earns profits on French soil.

The treatment of foreign companies which, according to the terms of the law (Decree of December 6th, 1872, Article 3), " have as their object property, whether movable or immovable, situate in France ", is the primary subject of this study. Accordingly, in order to make the explanations which follow clearer and the examination of the specimen cases considered more lucid, it will be well to set out the dominant principles of this treatment.

If a foreign corporation is to be liable for income tax, two conditions must be fulfilled :

(a) In the first place, the corporation must be a company of one of the types which, in the case of French companies, are liable for that tax. In other words, the foreign company must be either a corporation, a limited partnership, or non-commercial (*civile*) company.² Enterprises under the management of a private person in ordinary partnership or a company of one of the types which are exempt from this tax are not liable.

There is no difficulty whatever in determining the type of foreign companies having as their object property in France, if the law of the country of which the company possesses

¹ Under French law, the undertaking entered into by foreign corporations to pay the income tax by *abonnement* is binding on the corporations during the whole of their existence if the securities concerned are shares, or during the whole of the existence of the securities if they are bonds. Notwithstanding this undertaking, however, corporations sometimes cease to observe it; their securities then cease to be under the regime of *abonnement* and become securities not under *abonnement*, and the income tax must then be paid personally by the holders who are domiciled or resident in France under the conditions considered on page 64.

² See page 60, last paragraphs.

the nationality is substantially identical with French law. When, however, the law of the country in which the company is organised classifies companies in types appreciably different from those contemplated by French law, a foreign company is deemed to be taxable if, in view of its commercial or non-commercial (*civil*) character and the extent of the liability of its members, it can be regarded as closely analogous to one of the types of French company which the law specifies as being liable for this tax.

For example, English "limited" companies, whose capital is divided into shares and whose members are liable only up to the amount of their own holdings, are treated as equivalent to *sociétés anonymes*, and are taxable on the basis of the movable or real property they possess in France.

On the other hand, "unlimited" companies, whose members are liable for an indefinite amount, are treated on the same footing as French partnerships (*sociétés en nom collectif*). Similarly Lloyd's, the English insurance institution, escapes the tax because it is not a company but consists of groups of merchants having no joint responsibility.

(b) Secondly, the company must have as its object movable or real property situated in France. This expression means that French property must be included in the object for which the company was formed, and must thus, to some extent, be a factor in its operations.

The company's object thus includes the factory, warehouse or sales office owned in France by a foreign company manufacturing and selling metallurgical products; the buying office established in France by a foreign company whose object is to buy goods for resale; the office established in France for the sale of tickets by a foreign shipping company; loans granted in France and shares taken in French companies by a foreign banking company whose primary object is to deal in money and to finance enterprises; contracts concluded with persons domiciled in France by foreign insurance companies; French securities acquired by a foreign investment trust; the control of French companies or concerns acquired by industrial trusts constituted in the form of foreign companies, etc.

On the other hand, whenever the acquisition of property in France constitutes, for the foreign company acquiring it, an investment or employment of capital, the income tax is not payable, because, in that case, the acquisition is not involved by the normal object of the company—for instance, an industrial company which has in its portfolio shares or bonds of French corporations is not liable for tax on investments of this kind.

Apart from this, the provisions of French law are general in their operation. For example, in order to determine whether the tax is payable, there is no need to ascertain:

(1) Whether the company does or does not itself operate an establishment in France; a foreign company whose establishment is only a branch or agency and a foreign company which operates under cover of a French subsidiary company¹ are both equally liable for tax;

(2) Whether the French property is corporeal or incorporeal: just as a company which has an establishment in France is taxable, so is a company which grants loans to Frenchmen on mortgages secured on real estate situated in France, and so is a company which, in consideration of a royalty, licenses to a French concern the right to use a patent or a trade-mark in France;

(3) Whether the company is the owner or lessee of the French property it operates: a foreign hotel company which operates in a building that does not belong to it is liable for tax on the same basis as a company which owns its hotel building;

¹ The expression "subsidiary company" (*filiale*) or "affiliated corporation" will be applied in this study to any company constituted in due form, having a separate existence in law, but actually dependent on or controlled by another company. It must therefore not be taken to mean a secondary establishment belonging to the same concern.

(4) Whether the company actually draws income from its French property or not : a mining company is liable for tax on account of a concession it has obtained in France even if it does not actually exploit that concession ;

(5) Whether the property is the main or an accessory factor in the company's object : a foreign life-assurance company, being bound to form reserves to guarantee its liabilities, must pay tax on the investments it makes in France in the form of real estate or transferable securities, because these investments are involved in the company's object, which is subsidiarily to form reserves to offset its policies.

If a foreign company fulfils the two conditions set out above, it must pay tax on all the income it distributes to its shareholders, bondholders and creditors, and on the percentage of profits, attendance fees and miscellaneous emoluments it allows to those of its directors, who are domiciled or resident in France. But whereas it is liable for tax on the whole amount of such percentage of profits, attendance fees and miscellaneous emoluments, it is not liable in respect of dividends on its shares and interest on its bonds and loans beyond a certain proportion determined in the manner shown below.

Foreign Securities not under the Regime of the " Abonnement ".

The tax on income from transferable securities is not payable only in respect of French securities or foreign securities under *abonnement*. It is also payable on the income from all foreign securities for which foreign corporations have not contracted an *abonnement*, and on the directors' percentage of profits, attendance fees and miscellaneous emoluments in the case of companies that have not contracted an *abonnement* (Law of March 29th, 1914, Article 31, and Law of July 31st, 1929, Article 9).

In this case, however, the tax is of a personal character, inasmuch as it is only payable if the recipient of the income (shareholder, bondholder or creditor, or director) is domiciled or resident in France. In that case it is retained on behalf of the Treasury by the banker or exchange agent who pays the income in France, or it is paid annually on the basis of a declaration by the recipient who receives abroad the income from his securities. ¹

Special Position of Loans contracted in France by a Foreign Company. — Now that *abonnement* for bonds or loan instruments, of whatever nature, is no longer compulsory (Law of July 31st, 1929, Article 5), foreign companies which borrow from a French bank can choose between the following systems :

(1) Either they contract an *abonnement* in respect of their loan, in which case they are liable for tax on the income from the loan and can recover from their creditor in the same manner as other foreign companies which have contracted an *abonnement* ; the rate of tax is then 16 per cent ;

(2) Or they do not contract an *abonnement* in respect of the loan, in which case they have no liability towards the French Treasury, but their creditor must personally pay tax on the interest on the loan at the rate of 18 per cent.

¹ The rate of tax on income from foreign securities not under *abonnement* is higher (18%) than the rate applicable to income from French securities and foreign securities under *abonnement* (Law of April 26, 1930, Article 8) ; but in order to encourage the holding of foreign securities not under *abonnement*, the Law of July 31st, 1929 (Article 7), makes foreign securities of this class subject as regards income tax, to the same rate as French securities, provided that the holder deposits his securities with an approved bank in return for a receipt made out to him by name. This system was introduced primarily for the benefit of the holders, and not for that of the foreign corporations.

B. TAX ON INCOME FROM LOANS, DEPOSITS AND CASH SECURITY.

The tax on income from loans, deposits and cash security, like the tax on income from foreign transferable securities not under *abonnement*, has a personal character. It is payable by any natural or legal entity who is a creditor, on the sole ground that such person is either domiciled or habitually resident in France or possesses in France an industrial or commercial establishment to which the loan, deposit or cash security relates (Law of July 31st, 1917, Article 38, and Law of June 25th, 1920, Article 52).

Thus a private person domiciled or resident in France is liable for tax on the income from all loans and deposits he has made, irrespective of the nationality of the debtor or the situation of the security given; in particular, a company, whose domicile is compulsorily fixed by French law at the place where it has its seat (*siège*), is liable, if that place is in France, for tax on the income from loans or deposits made by its agency or branch abroad. Similarly, a person domiciled outside France or a foreign company is liable for tax on the income from loans, deposits and cash-security relating to his or its branch or agency in France. Conversely, every person domiciled and resident abroad, even if of French nationality, and every foreign company escapes the tax so far as concerns its loans to French debtors and its deposits in France.

Generally speaking, the tax on income from loans, deposits and cash-security is payable on all income from movable capital which is not liable for the tax on income from transferable securities.

The tax is leviable on interest, arrears and all other proceeds of:

(1) Mortgage, preferred and unsecured loans (*créances hypothécaires, privilégiées et chirographaires*). This tax applies, first, to the proceeds of non-commercial and commercial loans made to private persons or to firms not liable for the tax on income from transferable securities (partnerships, associations, etc.), and, secondly, to the proceeds of all other civil loans, irrespective of the nature of the transaction or act which gave rise thereto. On the other hand, the tax is not payable on the proceeds of commercial loans;¹ it thus does not apply to the discounting of, and interest on, commercial bills, or the interest on trade debts, nor to interest on current accounts when the recipient is liable for the tax on industrial and commercial profits, the tax on agricultural profits, or the proportional charge on mines.

(2) Cash deposits at sight or for a fixed period, whoever may be the depository (whether a private person, a company, or a public institution), and for whatever purpose the money may be intended.

(3) Cash-security—*i.e.*, funds deposited with a third party, according to law or under an obligation, as surety for the discharge of an undertaking.

If the payment of interest is stated in writing, the tax is paid in the form of stamps affixed either to the instrument or receipt or to the account to which the interest is credited or debited; the stamps are affixed by the creditor or the debtor who drafts the document.

¹ As an exception to this rule, however, the tax on income from loans is payable on the interest on that part of the sale price of a business and its stock which is not paid at the time when the contract is concluded (Law of July 11th, 1928, sole Article).

If the interest is paid in France without a document being drafted, or if it is paid abroad, the tax is payable by the creditor within the first quarter of the year following that in which the interest was paid, and for this purpose the creditor must make a special declaration at the registration office of his domicile.

The tax is payable by the creditor alone—*i.e.*, he may not, directly or indirectly, pass it on to the debtor (Law of July 31st, 1917, Article 40). This rule does not apply to the tax on income from securities, regarding which the parties may arrange between themselves.

4. PROPORTIONAL CHARGE ON MINES.

(Law of April 21st, 1810, Articles 33 to 37 ; Law of April 8th, 1910, Article 4 ; Law of April 30th, 1921, Article 3 ; Law of August 3rd, 1926, Article 23 ; Law of December 30th, 1928, Article 15 ; Law of April 16th, 1930, Article 63.)

This charge is payable on profits earned by concessionaires of mines *situate in France* from the operation of their concession.

It applies without regard to the nationality or domicile of the concessionaire.

Private persons domiciled, or companies having their head offices in France are therefore not liable for the charge in respect of any profits they may draw from mines *situate abroad*.

On the other hand, the charge is payable by foreign concerns working mines *situate in France*.

Mining profits are assessed in two different ways.

In the case of *French* companies (including those affiliated with foreign companies) liable for the tax on income from transferable securities, which work mines only in France and whose principal object is the working of those mines, the taxable profits are, as a rule, fixed arbitrarily (*forfaitairement*), at a figure equal to the amount voted, during the year previous to the year of the tax, in dividends or any other form of distribution of profits—in other words, at a figure equal to that taken for the assessment of the tax on income from securities payable by companies.¹

In the case of other mining concerns (whether operated by a private person or a company), the taxable net profit is the difference between the expenditures during the year previous to the year of the tax and the income actually received during the same year, that income including not only the proceeds of the sale of minerals extracted, but also the value of the quantity consumed by the concern.

All foreign concerns working mines in France are liable for the proportional charge on their net profits as assessed on this basis.

For the purpose of assessment, companies taxed on the arbitrary system (*système forfaitaire*) are not required to make a special declaration. They have merely to deposit in duplicate the documents required for the tax on income from securities ;² one copy is used for that tax, and the other for the proportional charge on mines.

Mining concerns not taxed on the arbitrary system must furnish the tax Administration every year with a detailed statement of their income and expenditure for the previous year, distinguishing (if both classes of income exist) income from outside sales from income from deliveries to their own enterprises.

The Administration verifies the statement and makes any adjustments that may be found necessary, and then uses it as a basis for assessing the taxable profits of concerns of this class.

¹ For particulars of this tax, see above, pages 60 to 64.

² For particulars regarding this tax, see below, pages 77 and 78.

5. TAX ON INDUSTRIAL AND COMMERCIAL PROFITS.

(Laws codified by the Decree of October 15th, 1926, Articles 1 to 22; Law of March 19th, 1928, Article 18; Law of December 30th, 1928, Articles 3 and 32; Law of March 30th, 1929, Article 18; Law of December 29th, 1929, Article 2; Law of March 31st, 1930, Article 8.)

This tax is payable only on the profits made on industrial or commercial enterprises operated in France.

Profits earned by private persons domiciled, or companies having their head offices, in France from the operation of *establishments situate abroad* are therefore not liable.

The tax is, however, payable on profits earned by companies having their head offices abroad from the operation of *establishments situate in France*.

For the purposes of the French fiscal law, an establishment is, in principle, any industrial or commercial organisation established on a permanent and autonomous basis. This includes, generally speaking, branches, factories, buying offices, warehouses, shops, and other places where profit-making operations are conducted.

SPECIAL CASE. — INSURANCE AND RE-INSURANCE COMPANIES.

French insurance companies are taxable only on the profits earned by their various establishments in France ¹.

The tax is accordingly not payable on profits earned by their agencies or branches abroad, provided that the conditions under which those agencies or branches do business are such as to give them the character of establishments operated outside France.

This character attaches, generally speaking, to agencies and branches established abroad if they are under separate management and keep separate accounts, and if the business they do concerns either property situate abroad or persons domiciled or habitually resident abroad.

Transactions effected by *foreign* insurance companies are deemed to be effected in an establishment situate in France if they involve the collection of premiums in France, Algeria or the French colonies and protectorates, or if they relate to risks in those territories. The companies are therefore taxable on the profits they derive from such transactions.

Special arrangements are made for French and foreign shipping insurance and re-insurance companies.

Under these arrangements, transactions arising out of compulsory re-insurance contracts between French and foreign companies in respect of risks abroad are deemed to be effected by an enterprise operated abroad, and the tax consequently does not apply to them.

Further, profits on shipping insurance or re-insurance policies issued abroad are not liable to the tax.

EXCEPTION. — MARITIME SHIPPING COMPANIES.

As an exception to the general principles set out above, profits derived by *foreign* maritime shipping companies from agencies or offices maintained by them in France for the purpose of obtaining freight for their vessels are exempt from the tax on industrial and commercial profits if the country whose flag is flown by their vessels allows equivalent exemption to French shipping companies.

Conversely, profits earned by French shipping companies in the same country and exempt from tax in that country are reckoned in the assessment for the tax on industrial and commercial profits for which the companies are liable in France.

¹ In this special case, France includes not only the mother country but also Algeria and the French colonies and protectorates.

Agreements for the reciprocal exemption of the profits of maritime shipping companies have been concluded by France with Belgium, Denmark, Germany, Greece, Italy, Netherlands, Norway, Sweden and the United States of America.

ASSESSMENT OF TAXABLE PROFITS.

The tax is assessed annually on the net profits earned, during the accounting period ending in the course of the previous year, in establishments operated in France.

For the purpose of the assessment the taxpayer (whether a private person or a company) must make an annual declaration of his taxable profits.

To this return he must, as a rule, attach a summary of his profit and loss account for the accounting period on the results of which the tax is assessed. Failing a summary of the profit and loss account, the taxpayer must attach to his declaration a "statement of profits" for the accounting period in question. This statement need only show the principal items which enter into the computation of the net profit—namely, gross profit, general expenses and amortisation charges; the gross profits may be estimated by applying to the total sales the average percentage of gross profit earned by the enterprise during the fiscal period.

Further, the taxpayer is generally required to produce, when demanded by agents of the administration, all accounts which may serve as evidence of the correctness of his declaration of profits.

The declaration is verified by reference to the profit and loss account or statement of profits attached thereto, and also by reference to the accounts.

It may be corrected, if necessary. In that case, the proposed correction is notified, with reasons, to the taxpayer, and if he disputes it the matter may, at his request or that of the administration, be referred to an Advisory Commission of traders and manufacturers.

The opinion of the Commission is not binding on the administration, which retains the right to assess the tax on whatever basis it thinks justified. If this basis is higher than that recommended by the Commission and if the taxpayer makes a complaint, the burden of proof before the courts is on the administration in so far as the profit assessed to tax is higher than the Commission's estimate. If, on the other hand, the figure on which the tax is assessed is fixed according to the Commission's recommendation, the taxpayer cannot secure a reduction by bringing a complaint before the courts unless he proves the exact amount of his profits.

To the procedure for correcting declarations and objecting to such corrections which has been described above, there is an exception in the case of persons and companies who do not furnish in support of their declarations a summary of their profit and loss account or a return of their profits, or who are not in a position to produce to the agents of the administration the necessary accounts to prove the correctness of the figures declared.

The declarations made by such persons and companies may be corrected by the authorities without previous notification of the grounds for correction and without intervention by the Commission.

The taxable profit is then assessed in each individual case by such methods as seem most suitable.¹

One of the commonest methods in such cases is to apply to the business turnover the average percentage of net profit ascertained in similar enterprises.

The particulars given above regarding the obligations of taxpayers and the procedure of taxation apply to the great majority of industrial and commercial enterprises. Provision

¹ The same applies if the taxpayer, having signed no declaration, finds himself taxed on the initiative of the authorities.

is made, however, for special methods in the case of foreign insurance and re-insurance companies, and these methods are explained below (pages 89 and 90).

6. TAX ON AGRICULTURAL PROFITS.

(Laws codified by the Decree of October 15th, 1926, Articles 30 to 40 ; Law of December 27th, 1927, Article 4 ; Law of December 30th, 1928, Articles 3, 10 and 12 ; Law of December 29th, 1929, Article 4 ; Law of March 31st, 1930, Article 10 ; Law of April 26th, 1930, Article 1.)

This tax is imposed on the income derived from the exploitation of land by tenant farmers, and farmers paying a proportion of their produce as rent (*métayers et colons partiaires*), or by the owners themselves, over and above the income the latter would derive from their properties if they merely leased them.

The tax is payable only on farm land *situate in France*.

Consequently, profits derived by private persons domiciled or companies having their head offices in France from the exploitation of properties situated abroad are not taxable.

On the other hand, the tax is payable on profits derived by persons domiciled or companies having their head offices abroad from the exploitation of farm land situate in France.

As a general rule, the tax is assessed on a profit which is calculated arbitrarily on the rental value of the land indicated in the land-tax register, which value is equal to $\frac{5}{4}$ of the income in respect of which the land is assessed for land tax¹.

In the case of arable land, the arbitrary agricultural profit is equal to $\frac{150}{100}$ of the rental value of the land.

The tax is, however, assessed on the actual profits of :

(1) Corporations, limited partnerships with share capital, and limited liability companies ;

(2) Industrial or commercial enterprises whose operations include the exploitation of agricultural land, if the agricultural losses or profits are shown in the general accounts of the enterprise.

In the case of those of the companies referred to above which exploit agricultural land but do not at the same time engage in industrial or commercial operations, the actual agricultural profit is shown by the balance of the profit and loss account.

In the case of companies engaging both in agriculture and in trade or industry—as in the case of other enterprises with a combination of objects whose accounts show both commercial or industrial and agricultural profits—steps are, as a rule, taken to apportion the profits between these two classes. If, however, the apportionment seems too unreliable, the tax may be assessed on the arbitrary agricultural profit, which is then deducted from the balance of the profit and loss account in order to ascertain the profit liable for the tax on industrial and commercial profits.

The companies and enterprises referred to above are alone required to sign an annual declaration of their actual agricultural profits for the previous accounting period. To this declaration they must attach a summary of their profit and loss account or a return of their profits, and they are also required to produce, on the demand of agents of the administration, all accounts which may serve as evidence of the correctness of the declaration.

¹ For particulars regarding this tax see above, pages 59 and 60.

As in the case of the tax on industrial and commercial profits, the Administration verifies the declarations by reference to the summary of the profit and loss account or the return of profits and by reference to the accounts, and, after making any necessary corrections, it then establishes the basis for taxation.

As regards taxpayers taxed on the arbitrary system, their taxable profits are assessed by the administration on the basis of the entries in the land register.

7. TAX ON SALARIES, ALLOWANCES AND EMOLUMENTS, WAGES, PENSIONS AND ANNUITIES.

(Laws codified by the Decree of October 15th, 1926, Articles 41 to 53 ; Law of December 27th, 1927, Article 7 ; Law of March 19th, 1928, Articles 21 and 22 ; Law of March 21st, 1928, sole article ; Law of December 30th, 1928, Articles 2 and 13 ; Law of March 30th, 1929, Article 17 ; Law of December 29th, 1929, Article 5 ; Law of June 30th, 1930, Article 28.)

The tax on salaries and wages, pensions and annuities is assessed at the taxpayer's place of domicile.

Consequently, every taxpayer, whether French or foreign, who is domiciled in France is taxable on any salaries, allowances, emoluments, wages, pensions and annuities he may receive, even if they come from abroad.

Conversely, income of the same kind acquired in France by a person resident abroad is not taxable in France.

The tax is paid annually on the salaries, allowances, emoluments, wages, pensions and annuities received by the taxpayer during the previous year.

It is assessed according to the circumstances existing on January 1st.

It follows from this that the salary, wages or pension drawn abroad by a taxpayer who settles in France during any given year is taxable in respect of the following year, because, on January 1st of the latter year, he was domiciled in France.

On the other hand, a taxpayer who leaves France during the year is no longer taxable on January 1st following in respect of the salaries, wages, pensions or annuities he has drawn in France, because at that date he was no longer domiciled in France.

As a general rule, the tax is assessed on the basis of the particulars (names and addresses of recipients of taxable income and amount of such income) supplied to the administration by employers, heads of enterprises and persons responsible for the payment of pensions or annuities.

8. TAX ON PROFITS FROM NON-COMMERCIAL OCCUPATIONS.

(Laws codified by the Decree of October 15th, 1926, Articles 54 to 65 ; Law of December 27th, 1927, Article 6 ; Law of December 30th, 1928, Article 2.)

The profits subject to this tax include income from the liberal professions (medicine, law, public functions, offices, etc.), professional income other than that derived from industry, trade, agriculture, public functions and private employments and, generally speaking, profit from any remunerative occupation or operations not subject to any other schedular tax. The tax on profits from non-commercial occupations is assessed at the place where the occupation is carried on, and according to the circumstances existing on January 1st.

Non-commercial profits earned abroad by persons established in France and having no permanent establishment abroad are therefore subject to this tax.

On the other hand, the tax is not applicable to similar profits earned in France by persons established abroad but having no permanent professional establishment in France.

For example, a doctor established in Switzerland who visits France from time to time to attend patients is not liable for the tax on profits from non-commercial occupations; but he would be so liable if he had an office or clinic in France.

In principle, the tax is assessed every year on the net profits for the previous year. In the case, however, of literary, scientific and artistic work, the income from which is not received annually, the taxable profit may, at the taxpayer's request, be assessed by deducting from the average income for the last five years the average expenditure for the same years. Taxpayers who adopt this method of assessment for any one year cannot, however, change their minds in subsequent years.

Persons liable for this tax are required to produce annually a declaration stating the amount of their gross profits, their professional expenses and their net profits for the previous year.

Writers, scientists and artists who elect to have their income assessed on the average income for the past five years must declare the amount of their gross income and professional expenses for each of those years, and the amount of the net profit represented by the excess of the average of those incomes over the average of those expenses.

The amount of profits declared is taken as a basis for the assessment of the tax unless there is any reason to question its accuracy. If, on the other hand, the agents of the administration have grounds for thinking it insufficient, they may correct it.

In this connection, they are entitled to ask the taxpayer for all particulars that may serve as evidence of the correctness of the various items (gross profit, professional expenses and net profit) mentioned in the declaration. Taxpayers engaged in a non-commercial occupation are not required to present accounts, and, consequently, the inspectors of direct taxation cannot judge the value of the information supplied to them except by comparing it either with such reliable data as may be in their possession or with such serious precise and concordant presumptions as they may have been able to obtain.

If they consider the particulars supplied to them insufficient, the agents of the Administration estimate the taxable profit from the information in their possession and notify the taxpayer of their estimate, stating the grounds for any increase they may have made over the declared profit.

If the taxpayer does not agree to this increase, it is compulsory for the dispute to be referred to an Advisory Commission composed of representatives of the liberal professions, which states the amount of professional income it thinks the taxpayer may be considered to have earned.

If this figure is taken as the basis for the tax, the taxpayer cannot obtain any reduction by bringing a complaint before the courts unless he produces proof of the exact amount of his profits. If, on the other hand, the tax is assessed on a figure above the Commission's estimate, the burden of proof in the event of a complaint is on the Administration to the extent that the figure taken as a basis for the tax is higher than the Commission's estimate.

PART II. — MANNER OF TAXING THE VARIOUS CLASSES OF INCOME.

In the first part of this study we have briefly explained the rules for the assessment of the various schedular taxes levied in France. We shall now consider the manner of taxing the various classes of income referred to in the questionnaire.

A and B. — DIVIDENDS AND INTEREST.

Dividends and interest on transferable securities received by a foreign enterprise under the management either of a single person or of partnership or of a company are subject to the tax on income from transferable securities in the following circumstances :

(1) In the case of income from French transferable securities (shares, part interests, bonds and loans), the tax is collected indirectly by the corporation which distributes the income, by deduction from the gross amount of the dividends, interest and other income. It is so retained irrespective of the place in which the income is actually paid, and of the nationality of the shareholder, associate or lender (see page 61, next to last paragraph) ; consequently, a foreign enterprise is liable for the tax in any case, whether it has an office or place of business in France or not.

(2) In the case of income from foreign securities of the same kind, a distinction must be drawn :

(a) If such securities have been subjected to *abonnement* by the corporation which issued them, the tax is payable in the same way as on French securities, but only if the income is paid in France. In exactly the same way as a French company the foreign corporation may make itself responsible for the French tax. If it decides to recover the tax, it deducts it in advance from the amount of each coupon paid in France ; and as the payment of a coupon in France gives rise to a presumption that the security from which the coupon was detached actually exists on French soil the company is entitled to deduct the amount of the French tax from all coupons cashed in France, irrespective of the nationality of the recipient (see page 62).

(b) If such securities have not been subjected to *abonnement*, an enterprise which does not have in France an establishment constituting its domicile¹ is not liable for the tax. It can accordingly obtain payment in France without any deduction, provided always

¹ In this connection, the Court of Cassation held on November 27th, 1923 (*Dalloz hebdomadaire*, 1924, page 22), that a foreign life assurance company required by the French law of March 17th, 1905, to have an autonomous establishment in France is thereby deemed to be domiciled in France, and must pay the tax on the income from foreign securities not under *abonnement* which it has deposited as surety for the discharge of its French engagements, and the coupons of which it cashes abroad. This is true, because the special provisions of Articles 7 and 12 of the Law of March 17th, 1905, and the Decree of June 26th to 28th, 1906, imposed on foreign life assurance companies desirous of operating in France the obligation to have an autonomous establishment in France, whereby they must be deemed to be domiciled in France for the purposes, more particularly, of the Law of March 29th, 1914. Whence it follows that the Court of the Seine, in rejecting the company's claim for refund of the tax and duties levied both on the coupons of foreign securities cashed in France and on those cashed abroad, did not act in contravention of any of the provisions referred to in the plea.

that, on presenting the coupon for collection, it produces an affidavit drawn up by the French diplomatic or consular agent within whose jurisdiction the enterprise is domiciled. If, on the other hand, the enterprise has a place of business or agency in France, and if the foreign securities not under "*abonnement*" belong to such place of business or agency, the enterprise must pay the tax on the income from its securities, even if the income was paid outside France (see page 64).

(c) A foreign enterprise under the management of a single person, a partnership, or a company is further liable for the tax on the income from debts due to it, deposits it has made, and security given in cash. In that case, however, the enterprise must have a permanent establishment in France, and the loan, deposit or cash security must belong to that establishment. Otherwise the tax is not leviable (see page 65, first two paragraphs).

C. — PATENT AND COPYRIGHT ROYALTIES.

I. *Patent Royalties.*

Profits from patents may be derived either from their direct exploitation, or from their indirect exploitation, or from their sale.

There is a case of direct exploitation when the inventor alone, or in association with other persons with whom he has formed a company to which he contributed his patent, manufactures the thing patented.

Profits from this form of exploitation of a patent are liable to the tax on industrial and commercial profits ¹.

French and foreign enterprises are not liable for this last-named tax on profits of this kind unless they are earned by an establishment situate in France.

The indirect exploitation of a patent consists in the granting of licences to exploit, either by the patentee or by his heirs or assigns, or by an assignee.

When the licences are granted by the inventor or his heirs or assigns, the royalties received under this head are subject to the tax on profits from non-commercial occupations.

This tax does not apply to royalties on licences granted in France by an inventor established abroad. On the other hand, inventors established in France are liable to the tax even on royalties derived from licences granted abroad. ²

When licences are granted by an assignee, who is generally a manufacturer, the royalties he receives on the licences he has granted form part of his working profits, and are consequently subject to the tax on industrial and commercial profits.

French and foreign enterprises are not liable for this tax on royalties of this kind unless the patent forms part of the assets of an establishment operated by them in France, in which case the tax is applicable to all royalties, including those in respect of licences granted abroad.

Lastly, as regards profits from the sale of patents, their taxation is dealt with as follows :

If the sale is made by the inventor himself or by his heirs or assigns, the profits thereon are not liable, according to the ruling of the Council of State ³, to any income tax, even if the sale is in consideration of an annual or periodical royalty.

¹ The same applies *a fortiori* to profits made by a manufacturer who has purchased a patent in order to manufacture the thing patented.

² As explained above in connection with this tax (see page 71), the taxable income of the recipients of royalty may, at their request, be determined by subtracting from the average income for the five years previous to the year of the tax the average expenditure for the same years.

³ Decision of May 16th, 1929 (see *Recueil général des lois et des arrêts*, by J. B. SIREY, 1929, III, page 89).

If, on the other hand, the sale is made either by a person or company habitually engaged in buying and selling patents or by an industrial enterprise of whose assets the patent formed part, the profits on the sale are subject to the tax on industrial and commercial profits.

Whether they are received by a French or a foreign enterprise, the profits in question are not taxable unless they are earned in an establishment situate in France. ¹

2. *Copyright Royalties.*

When collected either by the author himself or by his heirs or assigns (donees, legatees, etc.), copyright royalties are subject to the tax on profits from non-commercial occupations.

This tax is not payable unless the recipients of the royalties are established in France, but it is payable on royalties collected abroad as well as on those collected in France.

It will be remembered that, at the request of the taxpayer, the taxable profit may be determined by subtracting from the average income for the five years previous to the tax the average expenditure for the same years.

The Administration considers that the tax on profits from non-commercial occupations is also applicable in like circumstances to profits derived by an author from the transfer of his copyright to another person in consideration of a lump sum or an annual royalty or a royalty of so much per copy sold. Nevertheless, the Council of State might decide, as it has done in the case of profits from the sale of patents (see above), that the proceeds of the sale of a copyright are not income, and consequently are not subject to any schedular tax.

As regards the person to whom the copyright is sold, who is generally a publisher, he is liable, as such, for the tax on industrial and commercial profits in respect of the whole of his professional income, including that part which is derived specially from the exploitation of copyrights.

Profits of this latter class received by a French or foreign enterprise are not, in accordance with the principles governing the tax on industrial and commercial profits, taxed unless they are earned by an establishment situate in France.

D. — RENT FROM REAL ESTATE, MINING ROYALTIES, MINING PROFITS AND SIMILAR INCOME.

I. *Rent from Real Estate.*

Rent from buildings is subject to the buildings tax.

As regards lands not built over, the net income therefrom, includes on the one hand the rent of the ground—*i.e.*, the income the owner may derive from his land if he merely leases it, and on the other the income derived from the manual or directing work of the exploiter and from the operation of the capital represented by agricultural implements, agricultural machinery, cattle, seeds, manure, working capital necessary for the operation of the enterprise, etc.

This rent of the ground is subject to the land tax.

The other forms of income referred to above, which are not taken into account in the assessment of the land tax, are subject to the tax on agricultural profits. ²

¹ It should be stated that if a foreign company licenses its patents in France in consideration of a royalty, it is liable under that head for the tax on income from securities (see page 63).

² Consequently, a landowner who merely leases his land is liable only for the land tax, whereas the tenant farmer is liable only for the tax on agricultural profits.

On the other hand, a landowner who farms his own land or has it farmed under his own direction is liable both for the land tax and for the tax on agricultural profits.

This distinction being borne in mind, it will be remembered that only real property whether built upon or not, which is situate in France is subject to the tax, and that tax is applicable whether the landowner is established in France or elsewhere.

Similarly, the tax on agricultural profits is payable only on farm land situate in France.

French and foreign enterprises are consequently not liable for this latter tax on their profits from the exploitation of landed property situate abroad. If, however, they sell or work up in an establishment situate in France the produce of cultivation or stock-breeding on those estates, such enterprises are liable, in respect of the profits on such sales or processes, for the tax on industrial and commercial profits.

2. *Mining Royalties, Mining Profits and Similar Income.*

Mining royalties are not subject in France to any income tax. Profits derived from the exploitation of mines are subject to the proportional charge on mines.

This charge is not, however, made on income from saltmines, these being subject to the tax on industrial and commercial profits.

The latter tax is also leviable on profits from the working of surface-deposits, peat-deposits, slate-quarries, stone-quarries, and, in general, all extractive industries other than mining.

These principles being stated, we must now point out that French or foreign enterprises working mines other than saltmines are not liable for the proportional charge on mines unless they hold concessions for mines situate in France.

Consequently, if such enterprises work mines outside France, they are not liable for that charge; but if they sell or work up the ore extracted from those mines in an establishment situate in France, they are liable on that ground for the tax on industrial and commercial profits.

As regards French or foreign enterprises working saltmines, stone-quarries, slate-quarries, peat-deposits, etc., they are liable for the tax on industrial and commercial profits if their mines, etc., are situate in France. The same applies if, although the mines, etc., are situate outside France, the enterprises sell or process the products extracted therefrom in an establishment situate in France; in this latter case the tax is payable on the profits from the sale or processing of the products in question.

E. — PROFITS EARNED (1) BY A PRIVATE PERSON; (2) BY A COMMERCIAL OR INDUSTRIAL UNDERTAKING ON THE SALE OF SHARES OR BONDS AND ON THE SALE OF REAL ESTATE.

Profits earned by a private person on the purchase and sale of transferable securities must, if those transactions are purely *casual*, be regarded as mere fluctuations of capital and are therefore not to be taken into account in assessing the income tax.

The same applies to profits earned by a private person who *casually* sells real estate which he did not purchase for speculative purposes.

On the other hand, profits on the purchase and sale of transferable securities, when such transactions are *habitually*¹ effected by a private person as such, are subject to the tax on profits from non-commercial occupations.

This tax is payable both on profits from speculations abroad and on profits from speculations in France, but it is not applicable unless the recipient of the profit is established in France.

¹ The transactions in question must be regarded as being habitually effected if, in view of their frequency or periodicity, they provide a real occupation for the person who effects them.

As regards similar profits earned by an industrial or commercial enterprise, they are subject to the tax on industrial and commercial profits.

This tax is payable on all such profits which are earned in an establishment situate in France, whether on transactions effected in France or on transactions effected abroad.

Further, private persons and companies *habitually* engaging in the purchase of real estate with a view to resale are liable, in respect on their profits on such transactions, to the tax on industrial and commercial profits:

This tax is payable on purchases and sales of real estate, whether situate in France or abroad, but it applies to the profits on such transactions only if the latter are effected in an establishment in France.

Lastly, profits earned by industrial and commercial enterprises on the sale of real estate forming part of their assets must as a general rule be regarded as part of the net profits of the enterprise, and must consequently be included in the basis for the assessment of the tax on industrial and commercial profits for which they are liable.

According to a Ministerial decision of September 15th, 1925, however, these profits—like profits on sales of the various other forms of assets, except goods—must be exempt from tax if they are made in connection with the total or partial transfer of a business.

F. — INCOME FROM THE CARRYING-ON OF A TRADE OR BUSINESS THROUGH: (1) A COMMISSION-AGENT OR BROKER; (2) A TRAVELLING SALESMAN; (3) AN AGENT WITH POWER OF ATTORNEY; (4) AN AGENT SELLING OUT OF A STOCK OWNED BY THE FOREIGN ENTERPRISE; (5) A PERMANENT ESTABLISHMENT OF ANY KIND.

Foreign enterprises doing business in France through *commission-agents or brokers* are not, as a general rule, liable for the tax on industrial and commercial profits in respect of their profits from such business.

As regards *foreign* enterprises doing business in France through representatives (travelling salesmen, agents with power of attorney, or agents selling out of a stock owned by the foreign enterprise, etc.), their position as regards taxation may vary according to the special circumstances of each case.

If the representative merely collects orders from customers and forwards them to the foreign enterprise, without binding the enterprise in respect of the persons giving the orders, and without being concerned either in the delivery of the goods or in the collection of the price, the foreign corporation so represented is not regarded as having an establishment in France, and consequently is not liable in France for the tax on industrial and commercial profits.

On the other hand, the position is different, and the tax is payable, if the representative is actually in the position of a manager (*préposé*). Such may be the case if he occupies premises bearing the name of the foreign company, or if he is in possession of a stock of goods with which he fills orders, or if he has a power of attorney authorising him to deal direct with customers.

Again, *foreign* enterprises which have in France a completely autonomous establishment in which they carry on an industry or business are liable for the tax on industrial and commercial profits in respect of the profits earned in that establishment.

Conversely, *French* enterprises doing business with foreign countries through *commission-agents or brokers* are, as a general rule, taxable on the profits earned from such business.

With regard to *French* enterprises doing business with foreign countries through representatives or having an establishment abroad, their position as regards taxation is settled on the same principles as are set out above in the case of *foreign* enterprises.

If, on the lines laid down above, the representative can be regarded as having the status of a veritable manager, the profits earned by the *French* enterprise on business done abroad through the instrumentality of that manager are not to be included in the assessment for the tax on industrial and commercial profits for which the enterprise is liable in France.

If, on the other hand, the representative cannot be regarded as having the status of a manager, that tax is payable on the entire profits earned by the *French* enterprise, both from business done in France and from business done with foreign countries.

Lastly, *French* enterprises which have a permanent and completely autonomous establishment abroad are not liable for the tax on industrial and commercial profits in respect of their profit from the operation of that establishment.

G. — INCOME FROM A TRUST.

The Administration has not yet been called upon to decide the position of trust income from the point of view of taxation. It would seem, however, that the following view should prevail: The *cestui que trust* is to be regarded as a user who has appointed an agent to exercise his right of user, and in particular the right to collect for his own account the income from the *corpus* and to pay such charges as may exist thereon. Thus the income from the various properties forming the *corpus* does not lose its specific character, and consequently does not represent, in the hands of the *cestui que trust*, the income from a debt due to him by the trustee.

From the point of view of schedular taxation, therefore, it is necessary to determine the nature of the property administered by the trustee. If that property is in the form of real estate, the income of the trust has, in relation to French fiscal law and also in relation to the *cestui que trust*, the character of income from real estate; if the property is in the form of securities or loans, the income paid by the trustee represents income on movable capital. Consequently, whether schedular taxation can be levied in France on the income of a trust depends on the nationality of the property administered, and on the domicile or residence of the *cestui que trust*.

If the trust consists of real estate situate in France or of French transferable securities, the tax is paid, irrespective of the domicile of the *cestui que trust* or of the trustee, by the latter, who recovers it from the former by deducting it from the amount he pays to him.

If the trust consists of loans or foreign securities, the schedular tax is not payable unless the *cestui que trust* is domiciled or resident in France (see pages 64 and 65) it is paid by the trustee if the income from such loans and securities is collected in France, but, if not, the *cestui que trust* must pay it in person during the first quarter of the year in respect of income of that kind received during the previous year.

A to F. — SPECIAL REMARKS ON THE TAX ON INCOME FROM SECURITIES.

I. *French Companies.*

As explained on page 61 French companies pay the tax on the income from their shares or part-interests, bonds or loans, and the miscellaneous emoluments of their directors, irrespective of the nature of their profits or the place in which those profits were earned, and regardless of the fact that the company has already paid the schedular tax appropriate to the kind of income. Nevertheless, French law (Law of July 31st, 1920, Article 27, and Law of July 31st, 1929, Article 4) allows French share companies which have received shares, or bonds for contributions or payments to a French or foreign share company to deduct the income from such shares or bonds before calculating the tax on their dividend distribution.

In the case of shares, the taxable income is determined by the dividend fixed according to the decisions of general meetings of shareholders or boards of directors, or according to

reports or any other similar documents ; in the case of bonds and loans it is determined by the interest or income distributed during the year. For that purpose, the law requires companies to deposit with the Administration the reports and extracts from the deliberations of boards of directors or meetings of shareholders. Furthermore, companies are bound to produce, whenever required by inspectors of taxes, their books, ledgers and any other papers relating to their accounts.

II. *Foreign Companies.*

A foreign enterprise—when conducted by a company is liable for the tax on income from securities in respect of the profits it distributes when the French property producing the income it has received forms part of its object—*i.e.*, falls within the sphere of its activity (for the principle of this taxation see pages 62 and 63). If the possession of French securities (shares, bonds, loans, etc.) is in conformity with the object for which the company was formed, if the company has conceded its patents to a French enterprise, if, in the case of a publishing company, it receives fees from copyrights which have been transferred to it by French artists or authors, if it owns French real estate, otherwise than as a mere investment (see page 63), or is the concessionaire of French mineral deposits, or if it carries on a trade or business in France, it must, apart from the tax levied on the income from such properties, pay tax on the income from securities in respect of its distribution of the funds so acquired.

In particular, if the company carries on a trade or business in France, no distinction is to be drawn according to whether it carries on its activities through a permanent establishment, branch or subsidiary company or through a travelling salesman, even if he merely collects and forwards orders which are executed by the company itself, or through an agent with power of attorney, or an agent selling out of a stock owned by the company. On the other hand, the company is regarded as not carrying on its activities in France if its business is conducted through a broker or commission-agent—*i.e.*, through traders acting on their own behalf and not as representatives or agents of their principal ; in that case, the company is in the position of an enterprise receiving orders direct abroad, and is consequently not liable for income tax.

If a foreign company is liable for income tax in accordance with the above conditions (see also pages 62 *et seq.*), it must pay that tax, without any deduction for the taxes it has paid on its various classes of French income, on the taxable proportion of all the income it distributes. The amount distributed (dividends, interest and other forms of income) is determined as in the case of French companies (see above) ; for this purpose the foreign company is required to deposit with the Administration the same papers as French companies.

Generally speaking, the tax on income from securities is paid by companies (French companies or foreign companies under *abonnement*) in four equal instalments, within twenty days following the close of each quarter.

In the case of income from shares (dividends), these instalments are provisionally determined on the basis of four fifths of the income distributed during the previous fiscal period. At the close of the fiscal period, after the company's accounts connected with the matter have been made up, the amount of tax due in respect of that period is reviewed with reference to the dividends that have been distributed. If the result of this review is that additional tax must be paid, the additional tax is paid to the Treasury ; in the opposite case the excess tax already paid is refunded (Decree of December 6th, 1872, Article 1).

Thus the fiscal Administration takes no account of the calendar year in carrying out this general review, but adheres strictly to the fiscal period selected by the companies.

This rule applies, of course, to dividends distributed by foreign companies under *abonnement* (in respect of their securities in circulation in France or their property in France), to the extent of the taxable quota.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES AND SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

(a) METHODS OF APPORTIONMENT.

I. Tax on Industrial and Commercial Profits.

I. *Method of Separate Accounting and Empirical Methods.*

The taxable profits of French branches or subsidiary corporations of foreign concerns are, as a general rule, determined separately.

In principle, they are determined according to the declaration signed by the operating concern, which is checked with the documents (summary of profit and loss account or statement of profits) attached thereto, and with the accounts of the branch or subsidiary corporation.

It may happen, however, either that the branch keeps no separate accounts of its transactions¹ or that the subsidiary corporation or branch keeps accounts which do not show the real facts of the case. (This applies, for example, if deliveries made by the foreign concern to its subsidiary corporation or branch are invoiced at a conventional price in the neighbourhood of the sale price.)

In either case, the declaration is amended and the profit is estimated on the basis of the turnover of the branch or subsidiary corporation.

This estimate may be made by applying to the turnover the average percentage of *net profit* made by similar enterprises.

It may also be made by multiplying the turnover of the French establishment (subsidiary corporation or branch) by the coefficient of *gross profit* ascertained in the case of French concerns doing similar business, and subtracting from the result the overhead charges of the establishment.

If the French establishment is a branch, it is proper, in principle, to subtract also from the estimate of gross profit, in order to determine the net profit, that portion of the expenses of the head office of the foreign concern which is attributable to that establishment.

The expenses which may be so subtracted are those entailed by services of general value to the foreign concern as a whole.

As regards the part of the expenses in question which is attributable to the French establishment, it may be calculated by applying to those expenses the ascertained proportion between the turnover of that establishment and the general turnover of the whole of the foreign concern.

¹ The case of no separate accounts being kept is considered only in respect of branches, as subsidiary corporations necessarily have their own separate accounts.

Naturally, however, this form of empirical allocation must not be applied to expenses which can be apportioned direct. For instance, if the foreign concern keeps in touch with the operations of its French branch through a special service, whose expenditure is shown separately in its accounts, that expenditure is to be subtracted from the estimate of the gross profits of the branch.

2. Method of Fractional Apportionment.

If the accounts of the branch or subsidiary company do not show exactly the profit taxable in France, there is nothing to prevent the Administration, instead of following either of the two methods of assessment on turnover described above, from taking a suitable fraction of the entire income of the foreign company.

For this purpose, the Administration must be furnished with a summary of that company's general profit and loss account, and with any explanations that may be needed regarding the particulars contained therein.

The taxable profit may also be assessed on the quantity (number, weight or volume) of articles sold or manufactured.

For instance, the profits earned in France by a foreign enterprise having an establishment in France for the sale of typewriters may be determined by multiplying the number of typewriters sold by the amount of the net profit per typewriter made by French enterprises on sales of typewriters purchased abroad.

The assessment of the taxable profit may also be based arbitrarily on the capital invested in the French establishment, or may be effected by employing any other empirical method which will lead to a satisfactory result.

3. Requirements for Selection and Relative Value of Methods.

The profit should, in principle, be determined on the basis of the signed declaration and with the help of the separate accounts of the French establishment.

If, however, that establishment keeps no separate accounts of its transactions, or if it keeps accounts which do not show the results in their true light, the Administration may—subject to the right of the taxpayer to appeal to the courts—assess the taxable profits by the method which seems best suited to the particular case.

The method of separate accounting is considered to be the best method provided, of course, it reveals the true profits. Among the other methods, the most practical seems to be that of determining the profit on the basis of the turnover, by one of the two processes described (page 79), as there is then no need of examining the accounts of the foreign enterprise.

The most satisfactory of the latter methods is that which enables the profit to be assessed at a figure approximating as closely as possible that actually made by the French establishment.

The selection of a method is essentially a question to be determined by the facts of the case; a method which seems satisfactory in one case may prove defective in another.

II. Tax on Income from Securities.

Method of Fractional Apportionment exclusively employed.

The tax on income from transferable securities for which foreign companies having a branch or subsidiary corporation in France are liable is not payable on the sum total of the

income distributed by such companies, but only on a fraction of such income (other than directors' shares in profits).

This fraction is determined by applying to the total income distributed a proportion known as the taxable quota (*quotité imposable*). The taxable quota itself is fixed, for an invariable period of three years, not on the amount of the income actually drawn by the foreign company from its French branch or subsidiary corporation, but on the proportion represented by the value of the company's French assets to the value of its total assets.

An example will serve to make the machinery of this taxation easier to understand.

Suppose a company has assets amounting to 1,000,000 in France, its total assets being valued at 10,000,000: its taxable proportion will be $\frac{1,000,000}{10,000,000}$, or 1/10. If the company distributes a dividend of 1,000,000 and interest amounting to 100,000 francs, the proportion of the dividend subject to tax will be 1/10 of 1,000,000, and the proportion of the interest will be 1/10 of 100,000 francs.

If a French company refrains from recovering from its shareholders the amount of income-tax it has advanced on their behalf, it is deemed to have made a supplementary distribution of that amount, which is consequently also subject to tax.¹

For example, if a company distributes a net dividend of 100 francs, it is held to have distributed 116 francs, and it is on 116 francs that the tax is assessed.

After this preliminary explanation, we can now describe the method of apportionment used for the purpose of the tax on income from securities.

The income of the branch or subsidiary corporation is never determined separately. It is presumed—and foreign companies are not permitted to prove otherwise—to be in the same proportion to the total income² as the French assets are to the total assets. Consequently, according to the amount either of the income distributed or of the French assets, the tax is payable on a total income which may be greater or less than the profits actually earned on French soil; the tax is, moreover, payable on the sole ground that any income is distributed by the foreign company, even if its branch or subsidiary corporation in France is unproductive; but the tax is not payable if the company distributes no dividend or interest, even though the branch or subsidiary corporation in France makes a profit.

The method of taxation called the "taxable quota", which is described in the preceding paragraphs, is essentially an arbitrary method, and has the advantages and disadvantages inherent in that character. It must be accepted by the Administration even if the latter suffers by it, and by the companies even if it does not correspond to the facts. On the other hand, it protects the Treasury from any manipulation designed to reduce the profit earned in France; and it frees branches and subsidiary corporations from any enquiries or investigations to determine the income subject to the tax on income from transferable securities: only the balance-sheets of French branches and subsidiary corporations, estimates of assets in France, and declarations concerning business done in France, are subject to verification, because those documents form the basis on which the taxable quotas are fixed.

¹ According to the principle of equivalence of burdens as between French companies and foreign companies under *abonnement*, foreign companies that do not deduct the French tax from their dividends are liable, to the extent of the taxable quota, for tax on the dividend distributed plus the French tax.

This rule does not apply to interest on debentures or loans issued by companies, whether French or foreign.

² For the determination of total income, see particulars on page 77 and 78 for French companies, and for the determination and checking of the factors in the taxable proportion, see details on pages 87 to 89.

(b) APPORTIONMENT BETWEEN BRANCH AND PARENT ENTERPRISES.

I. Tax on Industrial and Commercial Profits.*1. Apportionment of Branch Profit to Real Centre of Management.*

The tax is payable on the whole of the profits earned by the French establishment from operations carried on in France.

In assessing these profits, however, a proportion of the expenses of the head office of the foreign enterprise should, in principle, be ascribed to the French establishment.¹ The expenses of which part is to be so ascribed are those which are of general concern to the foreign enterprise as a whole.

*2. Apportionment of a Part of Expenses of Real Centre of Management to Branch.**Interest on General Indebtedness.*

If the debt was specially contracted for the operation of a particular establishment, the whole of the interest must be included in the overhead charges of that establishment.

If, on the other hand, the debt was contracted for the needs of the concern as a whole, the interest must be distributed among the various establishments operated by the concern. The share of the interest attaching to each establishment is proportionate to the fraction of the loan which may be regarded as being specially used for the operations of that establishment.

General Overhead.

In order to determine the profits of the French establishment, the principle is that a proportion of the expenses of the centre of management of the foreign enterprise should be ascribed to that establishment.¹

The expenses to be so ascribed are those which are of general concern to the foreign enterprise as a whole, such as directors' fees, expenses of management and centralising accounts, and other expenses of a like kind.

The part of the expenditure in question which is to be ascribed to the French establishment represents the same proportion of those expenses as the proportion represented by the turnover of that establishment to the total turnover of the foreign enterprise as a whole.

This method of allocation does not apply, however, to expenses which can be actually determined. For instance, if a foreign enterprise had a central service to keep in touch with the operations of its French branch, and if the expenses of that service were accounted for separately, the amount of those expenses should be deducted from the profits made by that branch.

¹ This is not the case when the French establishment is operated by a subsidiary corporation, as the latter, although controlled by the parent company, is an entirely separate organisation, from whose profits there can be no question of deducting part of the parent company's expenses.

3. *Apportionment of Net Profit of Branch to Deficitary Parent, and vice versa.*

Because of the territorial nature of its tax, the branch is taxed without regard to the profits or losses of the parent.

II. Tax on Income from Securities.

In view of the fact that this tax is levied on the taxable quota of interest and dividends paid by the foreign company, there is no occasion to apportion any of the items of gross income or deductions, or the net profits or losses, between the branch and the parent.

As regards this tax no discrimination is made in the case of loan charges. In any event, the company must pay tax, in the taxable proportion, on the interest on all loans it has contracted—irrespective of whether they were contracted in France or abroad—for the needs of its French establishment, of the centre of management, or of its establishments situated outside France or outside the country in which it has its centre of management.

II. APPLICATION OF THE METHODS ALLOCATION OF IN SPECIFIC CASES.

(a) **INDUSTRIAL AND COMMERCIAL ENTERPRISES.**

I. Tax on Industrial and Commercial Profits.

I. Selling Establishments.

Local Establishment selling in National Market.

If the establishment operated in France keeps accounts which show the true results, the profits on sales¹ taxable in France are determined according to the figures in those accounts.

If not, the assessment is made comparatively, on the basis of turnover, by one of the methods described above.

Local Establishment selling abroad.

In the case in question, the profits derived from the sales made in the third State by the French branch are ascribed in their entirety to that branch.

2. Manufacturing Establishments.

If a foreign enterprise manufactures in France and sells abroad, the French establishment is taxable under a decision of the Council of State of July 25th, 1929.²

The taxable profit is equal to that which the French establishment would earn if it manufactured for sale or other parties the goods which it makes for delivery to the foreign selling establishment.

¹ These profits are those from sales only, excluding those from manufacture. Profits from sales in this sense are derived not only from sales in France, but also from sales made direct by the French establishment to foreign countries without the intervention of permanent establishments in those countries. The ground for the tax is that business is done in France through a permanent establishment situate in France, irrespective of where the contract is signed.

² *Revue des impôts sur le commerce et l'industrie*, by Edouard MAGUÉRO, 1930, No. 2832.

3. *Purchasing Establishments.*

Foreign enterprises purchasing goods in France with a view to manufacturing and selling in other countries are not liable for the tax on industrial and commercial profits unless they have in French territory a permanent organisation that can be regarded as an establishment according to the definition given in the first part of this study (see page 67).

Having to decide the case of a company whose head office is abroad, and which has an office in France under the management of a special manager, which buys goods for resale abroad, the Council of State ruled, by a decision of February 14th, 1930,¹ that the operation of this office in itself constitutes a commercial enterprise, and that the profit on the resale of goods so purchased in French territory is due, in part, to the conditions of purchase. It accordingly decided that, so far as the company's profits are derived from operations carried out in the French establishment (even if the actual payment is only made abroad), the company is liable for the tax on industrial and commercial profits.

It should be added that the profit taxable in France corresponds to the profit the buying establishment would make if it carried out for third parties the operations with which it is entrusted by its own firm.

4. *Statistical Bureaux; Display Rooms, etc.*

If a foreign enterprise has an establishment in France that does not directly engage in profit-making business but renders services to the enterprise which indirectly contribute to the earning of profits (*e.g.*, a statistical office or a showroom), its liability to tax would depend upon the circumstances of the case.

In regard to the two cases given as examples in the question, it may be stated that a foreign enterprise having an office in France whose sole object was to furnish it with statistics or information regarding the market demand, possible outlets for its goods, prices charged and sales made in France by competing enterprises, the amount of credit that might be allowed to possible buyers, etc., would be liable for the tax on industrial and commercial profits in respect of a profit corresponding to that which would be earned by an independent agency undertaking to furnish similar information to third parties.

As regards foreign firms having showrooms in France, they have necessarily an agent there who, if he does not make sales direct, gives information to customers and receives their orders for conveyance to the foreign enterprise.

The agent, being in charge of premises bearing the name of the firm, must (as stated on page 76) be regarded as a special manager, and the foreign enterprise must therefore be deemed to have, in France, an establishment which makes it liable for the tax on industrial and commercial profits.

II. **Tax on Income from Securities.**

As stated on pages 62 *et seq.*, a foreign company is liable for the tax on income from transferable securities if, generally, it owns property in France, and if, more particularly, it carries on its business there. A company which sells or buys on French soil is liable for that tax regardless of the method of carrying out those transactions.

¹ DUPONT'S *Bulletin des contributions directes et du cadastre*, 1930, page 189.

Furthermore, the tax is not assessed separately on the profits actually earned or presumed to be earned in France, but on a proportion of the profits distributed, varying according to the relative importance of the French branch or subsidiary corporation as compared with the undertaking as a whole.

Consequently, the tax is always payable on a fraction of the profits distributed by companies operating on the lines described below, and the questions relating to the determination of the income in the cases contemplated thus reduce themselves to one: how, in these cases, the taxable proportion of the profits distributed is established.

I. *Selling Establishments.*

In this case, a distinction must be drawn.

(1) If the company sells both in France and abroad the goods bought or manufactured outside France, the taxable proportion is fixed on the basis of the proportion between the total sales in France and the total sales everywhere.

(2) If the company sells in France only the goods it has bought abroad, the proportion is determined by comparison between the total sales in France and the total of sales plus purchases.

(3) If the company sells in France only the goods it has manufactured abroad, the proportion is established on the value of the French assets (goodwill, stock, fixtures, debts, etc.) as compared with the value of the total assets.

In principle, the taxable quota is determined by comparison between the amount of the French transactions and the amount of the total transactions.

In view, however, of the particular way in which the foreign company conducts its activities in France, it is advisable to explain what is meant by French transactions and what is meant by total transactions.

If two signatures are necessary for the conclusion of a transaction, the signature to be taken into account in determining whether the transaction was concluded in France or abroad is the later in date; if, apart from signatures signifying approval or sanction, this latest signature was affixed in France, the transaction is a French one; if it was affixed abroad, the transaction is a foreign one.

If, on the other hand, no document is drawn up to establish the contract, the transaction is French or foreign according to whether the offer of purchase or sale was accepted in France or abroad.

Consequently, a foreign company must reckon, not among its French business, but among its total business, all transactions concluded abroad by one of its agents empowered to bind it by his signature. On the other hand, any transaction resulting from the tacit acceptance (delivery) or explicit acceptance of orders sent direct from abroad to the French branch is a French transaction.

Lastly, if all the sales effected by the branch are to be regarded as being effected abroad, the quota is determined according to the relation between the value of the French assets (incorporeal value of the selling house) and the value of the total assets.

2. *Manufacturing Establishments.*

In the case of enterprises manufacturing in France and selling elsewhere the taxable proportion is established by comparison between the value of the French assets (factories, raw materials, goods, etc.) and the value of the total assets.

3. *Buying Establishments.*

In the case of enterprises continuously buying in France through a permanent establishment, but selling in another country the proportion is fixed on the basis of the relation between the amount of working capital allotted to the French purchasing house and the company's total capital.

If the foreign company has no branch or subsidiary corporation in France through which it makes its purchases, it is not liable for the tax on income from transferable securities.

4. *Statistical Bureaux, Display Rooms, etc.*

The case of enterprises possessing an establishment which does not engage directly in profit making business, but renders services to the enterprise by contributing indirectly to the earning of profits (statistical office, showroom, etc.) is an exceptional one, and the Administration has not met with any foreign companies whose enquiry or information offices or showrooms¹ in France do not conduct any operations coming within the scope of the company's object, or do not take orders, and consequently do no business in France.

Should the case arise in the future, the taxable proportion will have to be fixed by comparison between the French assets and the total assets, or by some other standard which will yield a result closer to the truth, such as a comparison between expenses occasioned by the French installation and total expenses.

(b) OTHER KINDS OF ENTERPRISES.

I. Tax on Industrial and Commercial Profits.

No special arrangements are made except in the case of foreign insurance and re-insurance companies.

These companies have the option of an arbitrary estimate of their taxable profits or the determination of their actual net income by the rules applicable to French companies.

They may change their choice every year. A company which has chosen the arbitrary estimate for one year may therefore adopt the system of taxation of actual income for the next year, or *vice versa*.

Arbitrary Estimate of Taxable Income. — Under the arbitrary estimate system, the taxable profit is determined by applying a suitable coefficient to the amount of premiums either collected by foreign enterprises in France, Algeria and the French colonies and protectorates, or corresponding to risks in those territories.

For every enterprise, this coefficient is equal to the ascertained proportion between taxable profits and premiums in the five most prosperous French companies insuring against risks of the same kind or engaged in the same business.

¹ By virtue of the international Convention signed at Paris, November 22nd, 1928, and approved in the case of France by the law of November 26th, 1929, an exemption from all taxes, and consequently the tax on income from securities, is accorded to foreign companies which participate in world expositions held in France, but on condition that such companies make no sale of goods from stock, but limit their activity merely to taking orders.

These coefficients are fixed annually by the Minister of Finance and the Minister of Labour, on the advice of a Board consisting of high officials and representatives of French and foreign insurance companies.

Foreign companies adopting the system of the arbitrary estimate of their taxable income must declare annually the amount of the premiums to be considered for the purpose of this estimate which they received during the previous year, showing separately the amount of the premiums in respect of each class of risk.

After checking this declaration, the Administration calculates the taxable income by multiplying the amount of the premiums to be considered in respect of each class of operation by the corresponding coefficient.

Taxation on Actual Profits according to the Rules applicable to French Companies. — In the case of foreign companies which prefer to be taxed according to the same rules as French companies, the taxable income represents the sum total of :

- (1) The net business profit earned in the territories in which their French management operates (France, Algeria and French colonies and protectorates) ; and,
- (2) The net income from movable or immovable capital employed as security for the operations carried out in these territories.

Certain of these operations are subject to French Government control, while others are not. ¹

In respect of controlled operations, foreign companies are required in all cases to keep separate accounts at their French centre of management ; in respect of uncontrolled operations, they are under that obligation if they prefer to be taxed on their actual profits.

Foreign insurance companies which have asked to be taxed according to the rules applicable to French companies are taxed on the profit as shown by these separate accounts ; a declaration of this profit must be made annually, and is checked by the Administration and amended, if necessary, after examination of the accounts.

II. Tax on Income from Securities.

As regards the tax on income from transferable securities, the methods² used for determining the taxable income are, as stated above, those which relate to the fixing of the taxable quota.

In principle, apart from special methods arranged for certain of the companies enumerated below, the elements on the basis of which the taxable quota is fixed are the following :

1. *Comparison of Assets.* — The respective values of French property and total property are ascertained from the balance-sheets for France and the general balance-sheets. ³

¹ Foreign enterprises operating in France are under the general control of the French State if they are engaged in life assurance, insurance against industrial accidents, or in the business of capitalisation and savings.

² These methods are established by the decisions of a commission known as the "Transferable Securities Commission" (Commission des Valeurs Mobilières), whose duty it is to determine the taxable quota of a company in every individual case.

³ By the general balance-sheet is meant the balance-sheet which shows the entire assets and liabilities of the company, both in the country in which it has its head office and in the other countries in which it has establishments.

In order, however, to obtain the value¹ of the French assets and that of the total assets, it is not sufficient to add up the items of assets in each of the balance-sheets and take the usual proportion. In addition, it is necessary to ascertain whether each of these items represents a real asset, and to eliminate those which merely represent suspense accounts (*e.g.*, expenses of first establishment), to verify whether the assets shown under an identical head in the two balance-sheets have a definite nationality and whether they are attached to each establishment, and to ignore those which have no definite nationality or which are common to the French and foreign establishments (value of a patent or industrial process); in this case it is presumed that the values in question form part of the French assets in the same proportion as other property.

After this preliminary work, in order to ensure that the taxable quota is really arbitrary (*forfaitaire*) as it should be, consideration is given, in respect of assets of variable value (goods in warehouse, cash in hand, debtors, bills, etc.), to the figures for three fiscal periods, the mean of these being taken; to this mean is added the value of plant and equipment at the date of striking the last balance, and, on the basis of the total so obtained, the proportion between the value of the French assets and the value of the total assets is established.

The particulars given in the balance-sheet generally serve as a basis for fixing the taxable quota, but the Administration has the right to check them. If it is established that, say, the French plant and equipment is shown in the balance-sheet at very much less than its real value, the Administration is entitled to substitute for that figure a different estimate, which is taken into account in the valuation of the French assets. Similarly, foreign companies may, provided they produce the necessary evidence, apply for an increase in the value of certain of their foreign property as shown in their balance-sheet, in order that the ratio on which the taxable proportion is based may be as close to the truth as possible.

If the foreign company does not draw up a separate balance-sheet for its French establishment, it is requested itself to estimate—subject to the Administration's right of checking as above—the proportion of the various items of its general balance-sheet which is represented by the value of its French property. A sort of fictitious balance-sheet is drawn up for the French branch, and is used in the way above described for the comparison between the two sets of assets.

For companies which have a French subsidiary corporation, the method of fixing the taxable quota is the same. As the comparative value of the French assets so owned or exploited, however, only that value is taken which corresponds to the holdings of the foreign company in its subsidiary corporation. If the foreign company holds eight-tenths of the shares of the French company, the value of the French assets to be compared with the value of the total assets will be eight-tenths of the estimated value of the assets of the subsidiary corporation.

The estimate of the assets of the subsidiary corporation is generally based on the company's balance-sheet. If, however, the company has attributed to its shares, for the assessment of the taxes for which it is liable, an estimated value higher than that shown in its balance-sheet, that estimate will be taken into consideration in ascertaining the amount of the company's capital and consequently the value of the holding of the foreign company.

2. *Comparison of Turnovers.* — If a foreign company's sole object in France is the sale of goods, and if it has no other industrial assets in France, the taxable quota is fixed on the basis of the relation between its French turnover and its total turnover, the nationality of transactions being determined on the lines indicated on page 85.

Lastly, when a company rents premises in France in order to manufacture on those premises goods for sale, the system employed for fixing the taxable quota is to compare the value of the

¹ The value in question is the real or sale value of all the assets, without deducting any debts or charges by which they may be burdened or assigned.

French property with that of the total property exploited by the company, and the turnover secured in France with the total turnover. The mean between the two proportions thus obtained gives the taxable proportion.

These are the two methods most generally followed. Occasionally, however, exceptions are made for certain specified concerns on account of the special nature of their business.

(a) *Banks and Banking Companies.* — For banks whose French business is confined to making loans either to private persons or to companies, the taxable quota is established by comparison between the amount of the loans in France and the value of the company's assets. The amount of the loans is shown by a detailed return, with names, of the debts due in France.

For banks which set up a branch or agencies in France to do every kind of business belonging to the special nature of such companies, the taxable quota is determined, as a general rule, by comparing the working capital allotted to the French branch with the company's entire capital.

If there is no such working capital, or if it is not commensurate with the amount of business done, the criterion taken is the proportion between the French turnover and the total turnover.

(b) *Insurance Companies.* — In order to determine the actual value of the French agencies, which is not as a rule shown in the balance-sheets of foreign insurance companies, the Administration proceeds as follows :

In the first place it ascertains the proportionate value of the French agencies to all the company's agencies. If no details are given in the balance-sheet, this figure is taken to be equivalent to the proportion between the French premiums—*i.e.*, the premiums payable in France under policies concluded in France—and the total premiums ; but as the premiums received only represent the company's business profit, whereas the profits it distributes are also derived from the yield of the investments representing its reserves, the proportion of the total profits represented by the business profits is ascertained.

This twofold operation may be expressed by the ratio :

$$\frac{\text{French premiums} \times \text{business profits.}}{\text{Total premiums} \times \text{total profits.}}$$

Frequently, however, foreign insurance companies operating in France hold French transferable securities and real property. This is the case with life assurance companies, which are bound under French law to secure their commitments in France by reserves partially constituted by French property.

The relative value of this property is determined by comparing the amount of the French investments with the total value of the company's assets (both as shown in the balance-sheets) ; it is then assumed that those investments contributed, in the proportion given by this comparison, to form the non-industrial profit, which is equal to the total profit less the business profit. The fraction thus obtained is added to the fraction representing the comparative value of the French agencies, and the reduction of these two fractions to one gives the taxable quota.

The mechanism of this operation will be made clearer by an example.

Suppose an insurance company has received French premiums representing 5 out of a total of 100, the business profit thereon being 2 out of a total profit of 4.

The comparative value of its French agencies is :

$$\frac{5 \times 2}{100 \times 4} = 0.025$$

If the company owns French property representing 1 out of assets of 100, its non-business profit being 2 (4 — 2), the comparative value of its French property is :

$$\frac{1 \times 2}{100 \times 4} = 0.005$$

Its taxable proportion will come out at $0.025 + 0.005 = 0.030$ or $3/100$.

(c) *Railroad, Motor-Bus and Other Transport Companies.* — As a general rule the taxable quota for railroad companies which hold a concession for a system or a portion of a system is obtained by comparing their French income with their total income. Only fares and freights collected in France are reckoned as French income, but if the company is a small one, and if its system consists of sections of track situated partly in France and partly abroad, the fares and freights in respect of the French section are reckoned as French income, wherever the money may actually be collected.

In the case of other transport companies (travel agencies), the taxable quota is determined by taking the mean between the three following proportions: (1) the proportion between the French assets and the total assets; (2) the proportion between the expenses incurred by the company in respect of its staff in France and those incurred in respect of the whole of its staff; (3) the proportion between the commissions collected in France and the total commissions collected.

Lastly, in the case of foreign shipping companies¹ whose vessels call at an authorised French port to pick up or land passengers or to load or unload goods, the taxable proportion is determined on the basis of the number and aggregate tonnage of the vessels and the number and tonnage of the vessels calling in France. By comparing these figures it is possible to ascertain what portion of the material is allocated to French business. The result of this calculation is further checked by comparing the value of freights and passage-money collected in France with the total income of the enterprise.²

(d) and (e) *Power, Light and Gas Companies.* — For companies of this kind which have an establishment and assets in France, the taxable quota is found by comparing the value of the works and other property in France and the total value of the French and foreign establishments (see pages 87 and 88).

(f) *Telegraph and Telephone Companies.* — The telegraph and telephone systems in French territory form a State monopoly, and no concession for these public services is granted to any private enterprise.

Consequently, the question relating to telegraph and telephone companies can only arise in regard to companies owning submarine cables. The taxable quota for foreign companies whose cables land in France, and which have an agency there, is determined by the ratio between the French business done and the total business done—*i.e.*, between the proceeds of the French traffic and the total proceeds of the telegrams despatched by the various stations which make up the company's complete system.

¹ Income-tax is not levied on foreign shipping companies whose countries reciprocally grant like exemption to French companies. These countries are Belgium, Denmark, Germany, Greece, Italy, Netherlands, Norway, Sweden and the United States of America.

² It is by this method that the taxable proportion for foreign air navigation companies will be determined, but so far the Administration has not been called upon to decide as to the application of this method to such enterprises. It will probably include either in the total income or in the total assets the amount of any subsidies such enterprises may receive from their country of origin.

(g) *Mining and Extractive Industries.* — In the case of companies which hold concessions for mineral deposits in France, the taxable quota is determined by comparing the tonnage extracted from the concessions in France with the total tonnage of the ores extracted by the company.

If the deposit for which a concession is granted in France is not worked, a comparison is made between the value of that deposit and the total assets of the company; the value of the deposit is obtained by estimating the quantity of ore in the deposit in tons and multiplying by the cost price or estimated value per ton.

B. NATIONAL ENTERPRISES WITH FOREIGN BRANCHES OR SUBSIDIARIES.

I. Tax on Industrial and Commercial Profits.

Three cases must be considered.

1. THE FRENCH ENTERPRISE HAS NO ESTABLISHMENT ABROAD.

In this case, the profits drawn by the French enterprise from its operations abroad must be subject to the tax on industrial and commercial profits on the same footing as its profits on operations in France.

For the purpose of assessment for tax, the undertaking must declare the whole of its profits from French and foreign sources; the declaration is checked by an examination of the documents (profit and loss account or return of profits) which must be attached thereto, and by inspection of the accounts.

2. THE FRENCH ENTERPRISE OPERATES ONE OR MORE ESTABLISHMENTS, ALL SITUATE ABROAD, AND HAS ONLY ITS SEAT IN FRANCE.

Having no establishment in France, the undertaking is not liable for the tax on industrial and commercial profits.

3. THE FRENCH ENTERPRISE OPERATES ESTABLISHMENTS SITUATE BOTH IN FRANCE AND ELSEWHERE.

Various cases, similar to those dealt with under the second question in regard to foreign enterprises having establishments both in France and elsewhere, may arise. We shall examine them one by one.

First Case: The French Enterprise has an Establishment in France and a Selling Branch Abroad.

(i) *The Branch buys and sells Abroad.* — The buying and selling being exclusively done by the branch, the whole of the profits of these operations must be regarded as being earned abroad, and are therefore to be ignored in assessing the tax.

Consequently, the basis for the taxation of the French undertaking must be determined by deducting these profits from the general balance of its profit and loss account.

(ii) *The Branch obtains its Supplies from the French Establishment.* — In this case, the profits earned by the foreign branch are derived from operations in which the foreign branch and the French establishment are both involved.

Consequently, these profits are taxed in France only in respect of that fraction which corresponds to the part of the operations that can be regarded as being carried out in France.

The part of the profits which is to be thus ascribed to the French establishment, and consequently taxed in France, should, as a general rule, correspond to the amount of the profits which the French establishment would earn on the manufacture or wholesale supply and export of the products supplied to the branch if it were manufacturing for or selling to third parties.

If the amount of this part cannot be exactly determined from the accounts, it should be determined by comparison by whichever of the methods described in the reply to the first question may seem most appropriate to the particular case.

Second Case: The French Enterprise has a Buying Office Abroad and a Selling Office in France.

In this case, the profits earned by the French enterprise are derived at the same time from purchases made abroad and from sales made by the French establishment.

Only the profits from these sales are taxable in France; they correspond to the profits the French enterprise would make if, instead of obtaining goods from its buying office abroad, it employed a French import commission agent or foreign export commission agent.

In principle, the amount of these profits should be determined on the basis of the general accounts kept in France, any necessary corrections being made in the books; in particular, the expenses on account of the foreign buying office should be deducted from the general expenses, but the purchase price of the goods despatched by that office should be increased by the amount of the commissions which would normally have been paid to the middlemen, referred to above, had their services been employed.

Following this system, the profit of the French establishment may be estimated by comparison on the basis of turnover.

Third Case: The French Enterprise has a Factory Abroad and a Selling Establishment in France.

In that case, it earns manufacturing profits, which are not taxable because they are made by an autonomous factory situate abroad, and it also earns sales profits, which are taxable because they are derived from operations carried out by the French establishment.

These profits correspond to those which the French enterprise would earn if, instead of obtaining its supplies from its own factory, it obtained them from independent foreign factories.

For the purpose of assessment, therefore, the profits in question must be separated from the general profits of the French enterprise.

If the accounts of the enterprise do not show the exact amount of these profits (as is the case when goods manufactured in the foreign factory are delivered to the French selling establishment at an artificial price approximating to the sale price), this amount may be determined by comparison, on the basis either of the sales effected by the French establishment or of the number, quantity or volume of the goods sold.

II. Tax on Income from Securities.

All the dividends, interest and other income from securities in French companies are subject to the tax on income from transferable securities, even though the funds from which such amounts were paid were derived from sources abroad.

Companies which have only their head office in France and do no business there, all of their establishments being situated abroad, are not liable for the tax on industrial and commercial profits.

Companies which have their factories abroad and selling establishments in France are liable for that tax only on the profits earned by those establishments.

These profits are to be determined in the manner described on page 92 (*third case*).

C. HOLDING COMPANIES.

I. NATIONAL HOLDING COMPANY CONTROLLING FOREIGN SUBSIDIARIES.

I. Tax on Industrial and Commercial Profits.

No special rules are laid down for determining the taxable profits of holding companies.

It may merely be stated that the profits of such companies are to a large extent constituted by the income from shares, holdings or bonds in the companies they control, or in any other companies in which they have invested capital.

In accordance with the rule followed for industrial and commercial enterprises in general, this income, which is already subject in France to the tax on income from movable capital, must, in order to avoid a duplication of tax in France, be deducted from the total net profits of the holding company, in order to determine the profit on which the tax on industrial and commercial profits for which the company is liable is to be assessed.

This deduction must be made after subtracting from the income from transferable securities the proportion of the expenses and charges which attaches thereto, this proportion being determined arbitrarily according to the ratio between the amount of such income and the total gross income of the company.

The taxable profits of holding companies are determined by their declarations, which are checked against their accounts.

II. Tax on Income from Securities.

French holding companies—*i.e.*, companies which, by holding shares in another company, exercise a right of investigation or an influence over that company, or which finance other companies by supplying them with the whole or part of the necessary funds, or which hold shares or bonds in other companies simply as an investment (investment trusts)—are liable for the tax on income from transferable securities in respect of all the profits they distribute in the form of dividends, interest or shares in profits.

In order, however, to avoid duplication of taxation, since the income they distribute is the same as the income they receive, French law lays down¹ that "when a French share company has received, in representation of payments or contributions in kind to a French or foreign share company, registered shares, bonds or stock, the dividends distributed by the first company are, for each fiscal period, exempt from income tax in respect of the income from such stock, bonds and shares received by the company during the fiscal period, provided that such stock, bonds and shares remain registered in the company's name" (Law of July 31st, 1920, Article 27, and Law of July 31st, 1929, Article 4).

¹ This law cannot be applied when the shares of the subsidiary have been bought on the market by the parent company.

Thus, when a French company has received from its French subsidiaries a yield amounting to 500,000 francs and from its foreign subsidiaries a yield amounting to 500,000 francs the dividend of 2,000,000 francs which that company will distribute during the fiscal period in the course of which it received those yields will be taxable only on 1,000,000 francs.¹

II. NATIONAL COMPANY CONTROLLED BY A FOREIGN HOLDING COMPANY.

I. Tax on Industrial and Commercial Profits.

The profits of the French subsidiary are determined according to the rules laid down in the reply to the first question.

II. Tax on Income from Securities.

If a foreign trust or holding company controls a French company, it is liable on that account (see page 72) for income tax on dividends and interest it distributes to the extent, of a taxable proportion corresponding to the value of its holding (see pages 87 and 88) as compared with the value of its total assets. Under French law, such a company is not allowed, as French companies are, to deduct from the amount it distributes the amount of the income it has received from its French subsidiary.

Thus, a foreign holding company or trust whose holding in a French company is worth 1,000,000 francs, and whose assets amount to 5,000,000 francs, is liable for tax on two-tenths of the income it distributes. If its dividend of 5,000,000 francs includes 500,000 francs income from its subsidiary, the company will have to pay tax on two-tenths of 5,000,000 francs—*i.e.*, 1,000,000 francs—although it has already paid the same tax on 500,000 francs on receiving its dividend from its subsidiary.

D. DIFFICULTIES AND RECOMMENDATIONS.

I. DIFFICULTIES ENCOUNTERED IN TAXING FOREIGN ENTERPRISES.

So far, the French Administration has met with no difficulties of an international character worth mentioning in connection with the various points dealt with in this study as concerns the assessment of the tax on industrial and commercial profits.

On the other hand, the application of the tax on income from securities to foreign companies owning or exploiting French property has given rise to certain difficulties. The chief complaints against French law concern :

(1) The whole principle of the tax, which is a form of duplicate taxation, since the introduction of the tax on industrial and commercial profits in France ;

¹ Article 30 of the French Law of July 31st, 1920, is as follows :

“ When, in order to secure the rights of the French holders, a French company collects the shares or bonds of one or more foreign companies and delivers, as representing those shares or bonds, special securities issued by itself and stating precisely what securities each of them is intended to replace, the yield from such securities shall, for each fiscal period, be exempt from income tax so far as it is shown that such yield corresponds to the dividends and interest distributed by the foreign company or companies for the same fiscal period, and that tax (*i.e.*, income tax) has been paid on that income.”

On account of the strict conditions it lays down, this rule has only been applied to a very limited extent ; moreover, it is primarily intended to cover the case of companies formed by holders of foreign securities for the purpose of exercising their right of investigation and control over the management of the foreign corporations which have issued those securities.

(2) The incidence of the tax, which ultimately falls upon foreign shareholders and bondholders, who, as such, should not be affected by French fiscal law ;

(3) The method of determining the taxable quota, which, being calculated on the French assets or French business, never takes into account the profits earned in France :

(4) The double taxation caused by the French system to the detriment of foreign companies controlling a French company, since in such cases the foreign companies have to pay tax on the dividends they receive from their subsidiary and then pay the same tax again, without any deduction of the amount already paid, in respect of their source of income in France.

The following arguments may be put forward in support of the present system of taxing foreign companies.

(a) Applied as it is without prejudice to the tax on industrial and commercial profits, the tax on income from transferable securities payable by foreign companies undoubtedly constitutes a duplication of taxation. Being based on a French legal fiction to the effect that the company has a separate legal personality from the personalities of its shareholders, these two taxes are supposed to be payable by two different taxpayers—first the company, on the profits it earns, and secondly the shareholders, on the ground of their increase in wealth due to the distribution of those profits.

This fiction is obviously quite inconsistent with facts, for a company simply manages, operates and makes productive, on behalf of its shareholders, the funds and property which the latter have contributed to the company or which it has acquired by re-investment.

Foreign companies cannot, however, complain of the imposition of the second tax on the profits they earn on French soil, seeing that from this point of view they receive the same treatment as French companies ; enjoying, like French companies, the protection of French law, they cannot logically object to the tax for which French companies are liable, nor can they claim to enjoy the same advantages without suffering the same disadvantages which attach thereto.

(b) Again, it is incorrect to say that, in levying a tax on profits distributed to foreign shareholders or bondholders, French law ignores their foreign nationality and taxes them in spite of it.

This charge does not apply only to the tax in question ; it may be made in connection with any other tax payable by the French establishment of a foreign company. Every direct or indirect tax or charge paid in France by the company means so much less profit for distribution by the company, and consequently, to the same extent as the tax on income from transferable securities, is indirectly borne by the shareholders.

(c) For the criticisms levelled against the method of fixing the taxable quota there seems much more justification. As it is a tax payable by reason of the earning of profits on French soil, the tax on income from transferable securities should logically cease to be payable if no profit is earned in France, and should be due only on the amount of such profit as is actually earned there.

But, as has been explained on page 81, French law has very wisely established this tax on an arbitrary (*forfaitaire*) basis, it being assumed that that fraction of the profits distributed which corresponds to the relative value of the French property or business as compared with the total property or profits was earned in France.

The enquiry now being conducted by the Fiscal Committee of the League of Nations into the apportionment of the profits earned by enterprises in each of the States in which they possess an establishment clearly illustrates the difficulty of accurately determining what proportion of their profits they earn in the territory of each of those States.

In the present state of affairs, each establishment, each branch and each subsidiary corporation does not constitute an autonomous establishment which has interests of its own and whose profits will be added arithmetically to the profits made by the others; they would seem rather to be the joint members of a single organisation, and it would seem to be their object to co-operate in the most various forms, through their business relations and their mutual connection, in the formation of a general profit. It is not possible to say that such an establishment has earned so much profit, because that establishment may not be, properly speaking, a branch of the company, but may serve to suppress competition which would be dangerous for the establishment situated in another country; in that case, it will generally appear from the books that the establishment is run at a loss, whereas actually it will have helped to increase the turnover of the other establishments, and therefore the general profit.

It is difficult, again, to distinguish the separate profits when, for fiscal or economic reasons, an establishment set up in a country is deliberately rendered unproductive. A company may impose on one of its foreign establishments either an increase in the price of the supplies with which it furnishes that establishment, or a decrease in the price of the goods which that establishment sells to the head office or to one of the branches or subsidiary corporations in a third country; in that case, that establishment will be rendered unproductive, but the profit of which it is deprived will appear in the books of the head office or the other branches or subsidiary corporations.

In view of all these facts, it does not seem possible to propose any solution but a system taking account *de eo quod plerumque fit*, and consequently involving, like the French taxable quota, the disadvantages of an arbitrary method.

In this respect, it is true, the taxable quota is inconsistent with the actual nature of the tax for the assessment of which it is used, because it places this tax, which is essentially designed to be imposed on income, on the assessment basis proper to a tax on capital.

On the other hand, it has two inherent advantages.

In the first place, it is of advantage to the Treasury, because the latter is able to prevent any manipulation aimed at concealing the profits earned on French soil or transferring them to another country, and to tax foreign companies controlling French subsidiary corporations. Secondly, it is of advantage to foreign companies, in that it spares them any dispute with the Treasury regarding the determination of taxable profits, and it places them under no other obligation than to declare their turnover and the figures of their balance-sheets, and to deposit the reports of their meetings.

(d) As regards the points dealt with above, although the system of taxation adopted by French law is justified there is no decisive argument for the legitimacy of the double taxation of foreign companies with holdings in French companies.

It is hard to see why profits received by foreign companies in the form of dividends from their subsidiary corporations should be twice subject to the same tax, first when they come into the possession of those companies and again when they are subsequently distributed.

On this point, the French Government has always said that it was prepared to amend its legislation. It does not, however, propose to make such changes except in favour of taxpayers who are nationals of countries which would themselves agree to correct their national legislation in such a way as to eliminate disadvantages of the same type.

II. RECOMMENDATIONS TO THE FISCAL COMMITTEE.

It would be desirable for the principal States to agree, after they have reached a common definition of an "establishment", that each of them will tax only the profits earned in establishments operated in its territory, and to adopt common rules for the apportionment of profits earned by enterprises having establishments in several States.

The measures so decided upon might be introduced by bilateral or multilateral agreements, according to the views of the League of Nations.

ANNEX.**TARIFFS APPLICABLE TO THE CALCULATION OF SCHEDULAR TAXES ON INCOME.****I. LAND TAX ON LANDS AND BUILDINGS.**

Besides the principal tax, which goes to the State, this tax includes additional percentages levied on behalf of the departments and communes.

The amount of the principal tax is 16 per cent of the taxable income (Law of April 26th, 1930, Article 1).

The amount of the departmental or communal taxes varies in different places.

II. TAX ON INCOME FROM MOVABLE CAPITAL.**A. Tax on Income from Transferable Securities.**

Nature of income	Rate of tax %	Most recent legislation fixing the rate.
1. French securities and foreign securities under <i>abonnement</i> .		
Dividends and other income from shares.	16	Law of April 26th, 1930, Article 7.
Interest, arrears and other income from bonds	16	Law of April 26th, 1930, Article 7.
Lottery winnings paid to holders of bonds	36	Law of August 3rd, 1926, Article 16.
Shares in profits, attendance fees and miscellaneous emoluments of directors. . .	18	Law of August 3rd, 1926, Article 16; and Law of April 26th, 1930, Article 7.
2. Foreign securities not under <i>abonnement</i> .		
All income.	18	Law of April 26th, 1930, Article 8.
Income from securities deposi- ted at bank in return for a registered certificate	16	Law of July 31st, 1929, Ar- ticle 7; and Law of April 26th, 1930, Article 8.
B. Tax on Income from Loans, Deposits and Cash Security.		
All income.	16	Law of April 26th, 1930, Article 8.

III. PROPORTIONAL CHARGE ON MINES.

Calculated at the rate of 25 per cent of the net taxable income (Law of August 3rd, 1926, Article 23).

IV. TAX ON INDUSTRIAL AND COMMERCIAL PROFITS.

(a) *Enterprises in general.*

The amount of the tax is fixed at the following rates :

	Total tax Francs
Profit of 800 francs or less	22.50
Profit of 801 to 1,500 francs	45.—
Profit of 1,501 to 3,000 francs	150.—
Profit of 3,001 to 5,000 francs	300.—
Profit of 5,001 to 7,000 francs	750.—
Profit of 7,001 to 10,000 francs	1,050.—
Profit of 10,001 to 15,000 francs	1,500.—
Profit of 15,001 to 20,000 francs	2,250.—
Profit of 20,001 to 25,000 francs	3,000.—
Profit of 25,001 to 30,000 francs	3,750.—
Profit of 30,001 to 35,000 francs	4,500.—
Profit of 35,001 to 40,000 francs	5,250.—
Profit of 40,001 to 45,000 francs	6,000.—
Profit of 45,001 to 50,000 francs	6,750.—

Above 50,000 francs the total amount of the tax is equal to 15 per cent of the profit, any fraction of the latter under 1,000 francs being neglected (Laws codified by the Decree of October 15th, 1926, Article 15).

(b) *Insurance and Re-insurance Enterprises and Enterprises engaging in Capitalisation or Savings Business.*

The tax is fixed at 20 per cent of the taxable profit (Laws codified by the Decree of October 15th, 1926, Article 20).

V. TAX ON AGRICULTURAL PROFITS.

Before the tax is assessed, every taxpayer is entitled to deduct from his taxable profit 500 francs for his wife, for every member of his family working and living with him, and for every dependant (relatives in the ascending line, collateral relatives, and foster-parents, if over 70 years of age or infirm, relatives in the descending line and foster-children under 21 years of age or infirm).

The tax is payable only on the amount by which the taxable profit, less the above deductions, exceeds, 2,500 francs.

Further, for the purpose of assessment, that portion of the profit which comes between 2,500 and 4,000 francs is reckoned at a quarter of its value, and that portion which comes between 4,000 and 8,000 francs is reckoned at half its value.

The rate of tax is 12 per cent (Laws codified by the Decree of October 15th, 1926, Article 33 ; Law of December 29th, 1929, Article 4 ; Law of March 31st, 1930, Article 10).

VI. TAX ON SALARIES AND WAGES, PENSIONS AND ANNUITIES.

Before assessment, every taxpayer is entitled to deduct, from the amount of his taxable income, 3,000 francs for his wife if she earns no wages and receives no income of her own, 3,000 francs for each of the first two children under 18 years of age and unsalaried, 4,000 francs for every child under 18 years of age and unsalaried, after the second child, and 2,000 francs for every other dependant (children between 18 and 21 years of age, infirm children over 21 years of age, relatives in the ascending line, collateral relatives, and foster-parents, over 70 years of age or infirm).

The tax is payable only on the amount by which the income, less the above deductions, exceeds 10,000 francs.

Further, for the purpose of assessment, that portion of the income which comes between 10,000 and 20,000 francs is reckoned at half its value, and that portion which comes between 20,000 and 40,000 francs is reckoned at three-quarters of its value.

The rate of tax is 10 per cent (Laws codified by the Decree of October 15th, 1926, Articles 47 and 48; Law of March 19th, 1928, Article 22; Law of December 30th, 1928, Article 2; Law of December 29th, 1929, Article 5).

VII. TAX ON PROFITS FROM NON-COMMERCIAL OCCUPATIONS.

(a) *Non-commercial Occupations other than Public (charges et offices) Offices.*

The tax is payable only on the amount by which the net taxable profit exceeds 10,000 francs.

Further, for the purpose of assessment, the portion which comes between the exempted minimum and 20,000 francs is reckoned at half its value, and the portion which comes between 20,000 and 40,000 francs is reckoned at three-quarters of its value.

The rate of tax is fixed at 12 per cent (Laws codified by the Decree of October 15th, 1926, Article 56; Law of December 30th, 1928, Article 2).

(b) *Public Offices.*

¶ Holders of public functions and offices such as notaries (*notaires*), solicitors (*avoués*), and bailiffs (*huissiers*), are taxed under the same conditions and at the same rates as are laid down for industrial and commercial profits (Laws codified by the Decree of October 15th, 1926, Article 56).

VIII. ABATEMENTS OF TAX FOR DEPENDANTS.

(Laws codified by the Decree of October 15th, 1926, Article 67; Law of December 29th, 1929, Article 6.)

On each of the taxes dealt with above, except the tax on income from movable capital and the proportional charge on mines, every taxpayer having dependants (relatives in the ascending line, collateral relatives and foster-parents if over 70 years of age or infirm, relatives in the descending line and foster-children under 21 years of age or infirm) is entitled to an abatement regulated as follows¹:

• For taxpayers whose net total income, as considered for the purpose of assessing the general income tax, does not exceed 30,000 francs, the abatement is at the rate of 10 per cent for the first two dependants and 20 per cent for every dependant after the second.

¹ In the case of the land tax, the abatements apply only to the principal tax.

For taxpayers whose net total income exceeds 30,000 francs, the abatement is at the rate of 5 per cent for each of the first three dependants and 10 per cent for every dependant after the third, provided always that the total abatement may not exceed 500 francs per dependant.

The above *abatements*, like the *deductions* for dependants provided for in connection with the tax on agricultural profits and the tax on *salaries and wages*, apply only to persons and not to companies.

Furthermore, foreign taxpayers are only entitled to these deductions and abatements on condition of reciprocity (Laws codified by the Decree of October 15, 1926, Article 104).

The table below shows the countries whose nationals are at present allowed the abatements in question :

Argentine Republic	Greece	Panama
Austria	Guatemala	Paraguay
Belgium	Haiti	Persia
Canada	Honduras	Peru
Chile	Hungary	Poland
Colombia	Italy	Roumania
Costa Rica	Japan	Siam
Czechoslovak Republic	Latvia	Spain
Denmark	Liberia	Sweden
Dominican Republic	Luxemburg	Switzerland
Ecuador	Mexico	Turkey
Estonia	Muscat	United States of America
Finland	Netherlands	Venezuela
Germany	Nicaragua	Yugoslavia
Great Britain	Norway	

TAX SYSTEM AND ALLOCATION METHODS IN GERMANY

BY

WERNER PAASCHE,

Ministerial Councillor,
Ministry of Finance of the German Reich.

PART I. — GENERAL DESCRIPTION OF THE INCOME TAX SYSTEM.

Income from commercial, industrial or other trading enterprises is subjected in Germany either to income tax (*Einkommensteuer*) or to corporation income tax (*Körperschaftsteuer*). The income tax and corporation income tax are Reich taxes, the yield of which is divided between the Reich, the *individual* States and the municipalities in accordance with the provisions of the so-called *Finanzausgleichsgesetz* (formulation of the publication of April 27th, 1926, *Reichsgesetzblatt I*, page 203, with amendments).

A. BRIEF SURVEY OF THE GERMAN INCOME TAX SYSTEM.

The income tax law (Law of August 10th, 1925, *Reichsgesetzblatt I*, page 189, with amendments) governs the taxation of the income of individuals; the corporation income tax law (Law of August 10th, 1925, *Reichsgesetzblatt I*, page 208, with amendments) deals with the taxation of the income of corporations, and estates, foundations and the like (*Vermögensmasse*). The corporation income tax applies especially in the case of companies formed for the purpose of gain, including, in particular, share companies (*Aktiengesellschaften*), limited partnerships with share capital (*Kommanditgesellschaften auf Aktien*), colonial companies (*Kolonialgesellschaften*), mining companies (*Bergsgewerkschaften*), private limited companies (*Gesellschaften mit beschränkter Haftung*) and partnerships (*Genossenschaften*), as well as other legal entities, associations of persons without legal entity (*nichtrechtsfähige Personenvereinigungen*), institutions (*Anstalten*), foundations (*Stiftungen*), and other property used for a particular purpose (*Zweckvermögen*). It should be mentioned that partnerships (*offene Handelsgesellschaften*), limited partnerships (*Kommanditgesellschaften*), and similar companies in which several persons participate as partners in the enterprise (*Mitunternehmer des Betriebes*) are not taxed as such, but the partners are taxed on their distributive share of the profits under the *Einkommensteuer*, if the partner is an individual, or the *Körperschaftsteuer*, if a corporation (§ 6, *KStG.*; §§ 29, No. 3, 65 paragraph 1, No. 2, *EStG.*).

A distinction is made, both in the income tax law and in the corporation income tax law, between *restricted* and *unrestricted* liability to tax.

(a) UNRESTRICTED TAX LIABILITY.

In order to be subject to unrestricted liability to the income tax, the individual taxpayer must have his domicile (*Wohnsitz*) in Germany, or the place where he habitually resides (*gewöhnlichen Aufenthalt*)—that is to say, resides for more than six months, in which case tax liability commences as from the beginning of the six months (§ 2, *EStG.*). To have unrestricted liability to the corporation tax, the corporation must have in Germany its seat (*Sitz*) or real centre of management (*Ort der Leitung*) (§ 2, *KStG.*).

A person has a domicile (*Wohnsitz*) within the meaning of German tax laws at the place where he maintains a dwelling-place under circumstances which indicate conclusively that he

intends to retain the possession thereof (§ 80, paragraph 1, of the *Reichsabgabenordnung* of May 22nd, 1931, *Reichsgesetzblatt* I, page 161). He has an habitual residence (*gewöhnlichen Aufenthalt*) at the place where he lives under circumstances which indicate conclusively that he intends not only to stay there temporarily (*A.O.*, § 81).

The seat (*Sitz*) of a corporation is the place which is designated as such in its statutes or memorandum of association. The real centre of management (*Ort der Leitung*) is the place at which the centre of the direction of the entire business is situated (§ 2, paragraph 2 of the regulations concerning the *KStG.*, *Reichsministerialblatt*, page 361, Decision of the Court of Finances of the Reich of June 16th, 1931, I A 462-30, *Sammlung der Entscheidungen des Reichsfinanzhofs*, Volume 29, page 78).

If the requirements of unrestricted liability are fulfilled, the entire income of a taxpayer is assessable without any regard to the source of the income, or to the fact that it has already been taxed in another country. Income consists of the following :

- (1) Income from agriculture, forestry, market-gardening and other cultivation of the soil of a not strictly trading character (income from agriculture and forestry) ;
- (2) Income from all kinds of commerce and industry ;
- (3) Income from carrying on an independent profession ;
- (4) Income from labour or employment (wages) ;
- (5) Income from capital ;
- (6) Income from leasing real property (*unbewegliches Vermögen*), aggregate property (*Sachinbegriffen*) and rights, including the presumed annual rental value when the taxpayer occupies his own house. (The term "aggregate property" (*Sachinbegriffen*) includes agricultural implements and material, movable working capital and any installation used in the exercise of an independent profession. The expression "rights" includes literary, artistic and commercial copyrights or patents) ;
- (7) Other recurring income ;
- (8) Certain other specified earnings on services (§ 6, *EStG.* ; § 10, paragraph 1, *KStG.*).

(b) RESTRICTED TAX LIABILITY.

Restricted liability to tax exists when the requirements for the unrestricted liability are not fulfilled—that is to say, if an individual has in Germany neither a domicile nor the place where he habitually resides, and if a corporation has in Germany neither its seat nor centre of management (§ 3, *EStG.* ; § 3, *KStG.*). The liability then covers only income derived from the following German sources :

- (1) Income from agriculture or forestry carried on in Germany ;
- (2) Income from all classes of commerce and industry for which an establishment (*Betriebsstätte*) is maintained in Germany or a permanent agent (*ständiger Vertreter*) has been appointed ;
- (3) Income from leasing real property, aggregate property (*Sachinbegriffen*) and rights which either are situated in Germany or registered in a German public book or register ;
- (4) Income from carrying on in Germany another independent profession ;
- (5) Income from labour or employment which is or has been performed in Germany ;
- (6) Income from mortgages (*Hypotheken*), land charges (*Grundschulden*) and other claims or rights which are secured on German real property or German rights pertaining to such property ;
- (7) Dividends, interest and any other income from shares, mining shares and participations (*Aktien, Kuxe, Genusscheine*) in German companies, shares in the Reichsbank,

in German colonial companies, participations in a mining company with legal entity, in German partnerships (*Genossenschaften*), and private limited companies (*Gesellschaften mit beschränkter Haftung*), except the income from preferred shares of the German Reichsbahngesellschaft ;

(8) Income from participation in a German enterprise as a silent partner ;

(9) Income from selling real estate in Germany or rights therein to which apply the provisions of the German civil code ;

(10) Regularly recurring payments made out of German public funds in respect of present or previous services, if not taxed according to No. 5 (§ 3, paragraph 2, *EStG.* ; § 3, paragraph 2, *KStG.*).

B. ASSESSMENT AND PAYMENT OF TAX.

With regard to assessment and to payment of tax, the following methods are in use—except for contrary provisions—and are employed both in respect of restricted and unrestricted liability.

(a) ASSESSMENT OF INCOME.

I. Determination of Income.

The income subject to tax is that earned by the taxpayer within the taxable period (§ 7 *EStG.* ; § 10, paragraph 1, *KStG.*).

Persons engaged in trade or industry, as well as legal entities liable to corporation tax (*Körperschaftsteuer*), who keep a set of books according to the requirements of the Commercial Code, whether they are bound to do so or not, have to take as taxable period the *business year* (*Wirtschaftsjahr*) for which they make the regular (annual) balances. Other persons liable to tax—with the exception of persons earning income from agriculture and forestry to whom special provisions apply—have to take the *calendar year* (§ 10, paragraph 1, *EStG.* ; § 12, paragraph 1, *KStG.*). If a person liable to income tax earns, besides his income from trade or industry, income from other sources, the taxable period for this income is the same as for the income from trade or industry.

As regards corporation tax, only *one* accounting year is allowed as basis for the total income of the taxpayer ; the results of this year must be summarised in one balance sheet (§ 12, paragraph 2, *KStG.*). If the liability to tax has not been existing during the whole calendar or accounting year, the taxable period is accordingly reduced (§ 10, paragraph 4, *EStG.* ; § 12, paragraph 3, *KStG.*).

If a company liable to corporation tax has not closed a new accounting year twelve months after the beginning of the liability or after closing of the last taxable period, the tax authority may without regard to the close of the accounting year determine this period of twelve months to be the taxable period (§ 12, paragraph 4, *KStG.*).

Income shall be regarded as earned within that taxable period in which it has fallen due or, without having been due, has been actually received by the taxpayers. If taxpayers make regular balances, the income is considered to be received during that taxable period for which it must be finally shown by a balance according to the principles of proper book-keeping (§ 11, *EStG.* ; § 10, *KStG.*). Corporation tax is payable whether or not the income is distributed to the partners, associates or members (§ 10, *KStG.*).

Book-keeping. — Every person engaged in commerce must keep account-books in accordance with the provisions of the Commercial Code (§ 38, *HGB.*). By a person engaged in commerce is meant, in the Commercial Code, a person carrying on a commercial trade (§ 1, *HGB.*). By a commercial trade is meant any trade concerned with one of the kinds of business

mentioned in § 1, paragraph 2, *HGB*. Even if it does not fall under these heads, a trade undertaking which, by its nature and scope, requires a business organisation on commercial lines is deemed to be a commercial trade if the *entrepreneur's* trade name is entered in the Commercial Register (§ 2, *HGB*.); it is the duty of the *entrepreneur* to see that such entry is made. The regulations regarding book-keeping do not apply to artisans or persons whose business does not exceed the dimensions of a "small trade" (§ 4, *HGB*.). The regulations applicable to persons engaged in commerce apply also to commercial companies (§ 6, paragraph 1, *HGB*.).

The books of account which persons engaged in commerce have to keep must show the business done and the disposition of his capital according to the principles of proper book-keeping. The person engaged in commerce must retain copies of all business letters which he sends, and keep these and the business letters which he receives arranged in proper order (§ 38, *HGB*.). Every person engaged in commerce must, upon *opening business*, make an exact statement of his immovable property, of all accounts receivable and accounts payable, of his amount of cash in hand, and of all other objects of property belonging to him, the value of each object of property being separately mentioned. He must draw up a balance-sheet showing the relation between his assets and his liabilities. Subsequently, he must prepare a similar balance-sheet at the *close* of every business year. The duration of the business year is not to exceed twelve months (§ 39, *HGB*.). In the inventory and balance-sheet each item of the assets and liabilities must be set down at the value which ought to be ascribed to it at the date in respect of which the inventory and the balance-sheet are drawn up (§ 40, *HGB*.). Special rules apply to mercantile associations (for instance, § 261, *HGB*., concerning share companies). Books of account, business letters, inventory and balance-sheets are to be retained for a period of ten years (§ 44, *HGB*.).

Profits. — The taxable income in the case of industrial or commercial enterprises is the profit realised (*Gewinn*). If the taxpayer keeps a set of books according to the requirements of the Commercial Code, whether he is bound to do so or not, the taxable profit is the excess, in accordance with good accounting rules, of the entire property of the enterprise at the close of the accounting period over the total property which at the close of the preceding period served as basis for computing tax. In determining the profit, money or goods appropriated by the taxpayer to his own use must be taken into account expenses, the deduction of which is allowed, must be deducted and certain appraisal regulations must be observed (§ 13, *EStG*.); § 13, *KStG*.). If books are not kept in accordance with the provisions of the Commercial Code, profit is to be regarded as the excess of receipts over expenditure, together with the "increased value", or less the "reduced value", of the products, the goods and supplies of the enterprise, of the buldings which are used by the enterprise and any appurtenances thereto, together with the movable assets at the close of the accounting period, as compared with the position at the close of the previous accounting period (§ 12, *EStG*.; § 13, *KStG*.). The term "income" includes all goods received by the taxpayer being money or money's worth; the allowable deductions include particularly the overhead expenses (*Werbungskosten*). The term "overhead expenses" ("*Werbungskosten*") means all necessary expenses made for obtaining, securing and maintaining the income (it includes interest on debts as far as they do not belong to the overhead expenses (*Werbungskosten*), and have no economical connection with income not taken into account for assessment). For taxpayers having a proper system of book-keeping, the term includes such amounts that are used for balancing a loss, which, according to the results of book-keeping, was incurred during the two accounting periods immediately preceding (carrying forward of a loss) (§ 15 to 18, *EStG*.; § 13 to 17, *KStG*.). Taxpayers having restricted liability to tax are not allowed to carry forward a loss, but may deduct overhead expenses (*Werbungskosten*) and interest on debts in so far as they are economically connected with taxable income (§ 15, par. 2, *EStG*.; § 13, *KStG*.).

2. *Declarations.*

The taxpayer is bound regularly to make a declaration regarding the amount and kind of his income. In this declaration, the taxpayer must give an assurance that his information is correct, according to the best of his knowledge and belief. A declaration has to be presented

- (1) By individuals whose income in the taxable period exceeds 8,000 Reichsmarks ;
- (2) Without regard to the amount of income :
 - (a) By taxpayers whose taxable income is determined on the basis of the balance-sheet,
 - (b) By taxpayers who are particularly requested by the tax authority to present a declaration.

Taxpayers may further be requested to declare their living expenses, the amount of remunerations of all kind paid during the accounting period to members of the board of directors, the amount of dividends paid during the accounting period—provided they are not paid out of capital which during its formation in the last three years has been subjected to corporation tax—and, finally, the amount of percentages (*Tantiemen*), remunerations and bonuses paid during the accounting period to directors and higher employees without being agreed by contract (§ 61, *EStG.*; § 22, *KStG.*). Taxpayers who reside abroad or have their centre of management in a foreign country, but possess, in Germany, taxable property or a permanent establishment or business office, or are otherwise liable to tax, must, on the request of the tax authority, appoint a representative in Germany who is authorised to receive written documents and papers for them. If they fail to do so, a written document is considered to be delivered when posted even if it is returned as undeliverable (§ 89, *A.O.*).

3. *Duty of supplying Information.*

The taxpayer must supply the written or oral information required by the fiscal authorities truthfully and according to his best knowledge and belief. If the authorities demand it, he must be prepared to prove the correctness of his declaration and submit for examination and verification the records, books and business papers, as well as any documents which are relevant for the assessment of the tax (§171, *A.O.*). Cases may occur where the taxpayer will be compelled to make a sworn declaration to corroborate the facts which he has stated (§ 174, *A.O.*). Taxpayers who keep books within the meaning of the Commercial Code have to supply, if requested, a copy of their unabridged balance-sheets with explanations, and of their profit and loss account (§ 172, *A.O.*).

4. *Duty of Third Parties to supply Information.*

In addition, persons who are not involved in the assessment of the tax in a given case have to supply truthful information to the tax authorities regarding facts which are relevant in determining the amount of the tax assessable by the authorities. They may also be required to swear to the truth of their statements, and to produce specified documents or letters. Just as in the case of (3) above, the demands of the tax authorities are enforceable (§§ 175, 182 and 183, *A.O.*).

5. *Advice of Experts.*

The tax authorities may, moreover, seek the advice of Experts, may consult auditing officials attached to them, or make use of the assistance of representatives and employees of the various trade associations as well as of the representations of the trade or business branches to which the taxpayer belongs (§ 206 A.O.).

6. *Audit of Taxpayers' Books and Enterprises.*

In the ordinary course, larger firms are audited at least once every three years by properly trained officials or by expert employees of the Ministry of Finance. The audit covers all matters which may be relevant for taxation and covers at any rate the period from the last audit (§ 162, No. 10, A.O.).

7. *Estimated Figures.*

Properly kept books and records, correctly stating the facts, are as a rule to form the basis for taxation. If the tax authorities cannot determine or compute the basis of taxation, they must, with due regard to all circumstances material to the case, make an estimate. They must resort to this measure especially if the taxpayer is unable to give sufficient explanation regarding his statement or refuses to give any further information or to make a declaration under oath. This is also applicable in the case where a taxpayer is unable to produce the books or statements which he has to keep under the tax laws, or if the books and records are incomplete or are incorrect as to form or fact (§ 217, A.O.).

(b) ASSESSMENT AND RATES OF TAX.

1. *Assessment.*

If the assessment results in fixing a tax, the tax authority gives a written notice to the taxpayer (§64, E StG.; § 22, KStG.). No assessment for income tax will take place if the total revenue does not exceed an amount of 8,000 RM. and if it consists only of income from which the tax has been withheld (page 110) (§ 89, EStG.). If it does not exceed the amount of 8,000 RM. but consists, apart from the income having been subjected to withholding of tax at source, of other revenues, an assessment of the total income will take place. The assessment may, however, be restricted to these other revenues; no assessment is necessary if this other income does not exceed 500 RM. (§ 90, EStG.). If a taxpayer, liable to corporation tax and not being a company formed for the purpose of gain which is subject to unrestricted liability to tax (see page 103), has—besides his income from which the tax has been withheld, and which has not been derived from a German agricultural or forestry enterprise or from commerce and industry in Germany—earned other income amounting to over 500 RM., the "other income" is taxed; if the "other income" is less than 500 RM., no assessment is made (§ 26, KStG.).

If, according to this, no assessment takes place, or if it is restricted to the "other income", the tax due is deemed to be paid in so far as a tax has been withheld at the source, provided that the retention at the source has taken place in due order, and that the amount withheld has been discharged according to the provisions.

2. *Tax Rates.*

The income and corporation taxes are levied at the following rates:

Income Tax. — For the computation of the income tax, the income less certain deductions (e.g., family allowances) is rounded off to the following amounts (*Steuerstufen*):

Income exceeding	50	but not	150	RM. to	100	RM.
"	150	"	275	"	200	"
"	275	"	425	"	350	"
"	425	"	575	"	500	"
"	575	"	725	"	600	"
"	725	"	900	"	800	"
"	900	"	1,050	"	1,000	"
"	1,050	"	1,350	"	1,200	"
"	1,350	"	1,650	"	1,500	"
"	1,650	"	1,950	"	1,800	"
"	1,950	"	2,250	"	2,100	"
"	2,250	"	2,600	"	2,400	"
"	2,600	"	3,000	"	2,800	"
"	3,000	"	3,400	"	3,200	"
"	3,400	"	3,800	"	3,600	"
"	3,800	"	4,250	"	4,000	"
"	4,250	"	4,750	"	4,500	"
"	4,750	"	5,250	"	5,000	"
"	5,250	"	5,750	"	5,500	"
"	5,750	"	6,250	"	6,000	"
"	6,250	"	6,750	"	6,500	"
"	6,750	"	7,250	"	7,000	"
"	7,250	"	7,750	"	7,500	"
"	7,750	"	8,250	"	8,000	"
"	8,250	"	8,750	"	8,500	"
"	8,750	"	9,250	"	9,000	"
"	9,250	"	9,750	"	9,500	"
"	9,750	"	10,250	"	10,000	"
"	10,250	"	10,750	"	10,500	"
"	10,750	"	11,250	"	11,000	"
"	11,250	"	11,750	"	11,500	"
"	11,750	"	12,500	"	12,000	"

(\$ 54, *ESG.*)

The income tax is payable (according to § 55, *ESG.*) as follows :

For the first 8,000 RM. of income, whether this amount be fractional or complete, 10 per cent ;

For the next 4,000 RM. of income, whether this amount be fractional or complete, 12½ per cent ;

For the next 4,000 RM. of income, whether this amount be fractional or complete, 15 per cent.;

For the next 4,000 RM. of income, whether this amount be fractional or complete, 20 per cent ;

For the next 8,000 RM. of income, whether this amount be fractional or complete, 25 per cent ;

For the next 18,000 RM. of income, whether this amount be fractional or complete, 30 per cent ;

For the next 34,000 RM. of income, whether this amount be fractional or complete, 35 per cent ;

For all further amounts of income, 40 per cent.

The income tax is not assessed if the income of the taxpayer is less than 1,300 RM. the year. This provision, as well as that concerning certain deductions from the income—e.g., family allowances—do not apply to persons subject to restricted liability (§ 50, paragraph 1, § 60, paragraph 2, *EStG.*).

In the case of persons subject to restricted liability, the income tax for income of the categories indicated on pages 104 and 105, paragraphs 4 to 10, which has not been derived from agriculture or forestry, or from commerce or industry, amounts to 10 per cent, even if the income exceeds 8,000 RM. (§ 60, *EStG.*).

According to Article 1 of the second amendment to the income tax law, dated July 23rd, 1928 (*Reichsgesetzblatt I*, page 290), the assessed income tax is reduced by 25 per cent, but by no more than 36 RM. a year if the income does not exceed an amount of 15,000 RM. According to Part 2, Chapter IV, Article 1, section 1, of the Decree of the President of the Reich concerning the protection of economy and finances, dated December 1st, 1930 (*Reichsgesetzblatt I*, page 517), persons liable to income tax who are to be assessed for the calendar year 1930, or for an accounting period ending in this calendar year, on account of an income exceeding 8,000 RM., have to make an additional payment of 5 per cent on the income tax.

Corporation Tax. — The corporation tax for companies formed for the purpose of gain, and being here principally in question (page 103), is generally 20 per cent of the income. Under certain circumstances, co-operative societies and private limited companies pay tax according to a progressive scale; also, in this case, the highest rate is 20 per cent. In the case of trading companies subject to restricted tax liability (page 104), the corporation tax to be paid on income of the categories indicated on pages 104 and 105, paragraphs 4 to 10, amounts to 10 per cent of the income, provided that this income has not been derived from a German agricultural or forestry enterprise or from commerce or industry in Germany (§ 21, *KStG.*).

Holding and trust companies (*Kapitalverwaltungsgesellschaften*) are entitled, under certain conditions, to tax reductions. As a general rule, undertakings organised in the form of companies by shares (*Aktiengesellschaften*), the object of which is the purchase, management and sale of certain kinds of shares, participations in mining companies (*Kuxen*) and interests in other companies, or of bonds, and the centre of management of which is situated within the country, are considered to be holding and trust companies. As regards the tax on the income of companies, the reduction consists in taking into account, when assessing the profits derived from the ownership or sale of the securities, only one-tenth of the amount at which they ought to be computed for this purpose (§ 11, sub-section 1, No. 3, sub-section 2, No. 3, of the Law on the Tax on the Income of Companies; Part VII, Chapter 4, of the Second Economic and Financial Settlement Order of the President of the Reich of June 5th, 1931 (*Reichsgesetzblatt I*, page 279; Holding and Trust Companies (*Kapitalverwaltungsgesellschaften*) Tax Law of July 24th, 1931 (*Reichsgesetzblatt I*, page 411).

(c) PAYMENT OF TAX.

1. Retention at Source.

In certain cases, the tax is collected by withholding it at source; the law indicates two kinds of retention:

(a) *Withholding of tax on income from wages (Steuerabzug vom Arbeitslohn)*, which is effected, as far as income from labour and employment is concerned, by the employer by way of deducting a certain part from salary and wages (§ 69 and following, *EStG.*); and

(b) *Withholding of tax on the yield of capital (Steuerabzug vom Kapitalertrag)*, which is to be effected in the case of certain capital returns by the debtor of these returns by way of withholding a tax of 10 per cent of the full yield of capital without any deduction

for interest on debts, for *Werbungskosten*, and for the amount to be withheld as tax (§ 83 and following, *EStG.*).

As yield from capital property in Germany are to be deemed only :

(1) Dividends, interest and any other income from shares, mining shares and participations (*Aktien, Kuxe, Genuss-scheine*) in German companies, shares in the Reichsbank, in German colonial companies, participations in a mining company with legal personality, in German associations (*Genossenschaften*), provided the interest in the case of the latter does not exceed 10 R.M. per member and year ; an exception is made for the income from preferred shares of the German Reichsbahngesellschaft ;

(2) Income from participation in a German enterprise as a silent partner.

This income from capital is to be considered as derived in Germany, if the seat or the centre of management of the debtor is situate in Germany. The withholding is also to be effected if the income from capital arises in a commercial enterprise. The debtor of the income is bound to withhold the tax for the account of the creditor when the payment falls due, and to deliver within one week the retained amount to the tax authority in the district of the debtor. The debtor must deliver the tax even if the creditor fails to claim the income.

2. *Advance Payments.*

If the tax is not collected by way of withholding at the source, advance and final payments are to be made (§ 68, *EStG.* ; § 24, *KStG.*). Until he receives an assessment notice for an accounting period, the taxpayer has, according to these provisions, to make advance payments on the tax due for this accounting period on April 10th, July 10th, October 10th and January 10th, amounting to one-quarter of the tax which has been assessed for the preceding year. If the total income has been assessed because it exceeded the amount of 8,000 R.M., inclusive of the income subjected to direct withholding, according to the preceding paragraph 1, the taxpayer has, until he receives the next assessment notice, to make advance payments only in so far as the tax due is not covered by the amounts being withheld during the accounting period which has been the basis for the assessment (§§ 95, 96, *EStG.*). In the case of liability newly originating, the advance payments are to be fixed according to the income which is supposed to be earned in the year following the origin of the liability (§ 98, *EStG.* ; § 24, *KStG.*). If it is probable that the income will increase in comparison with that assessed for the preceding year by more than a fifth, the advance payments may be revised. This may be done also if income which is subject to withholding at source will be probably substituted by other income amounting to more than 2,000 R.M. In contrary cases, respite may be granted upon application for the corresponding part of the advance payments (§§ 99, 100, *EStG.* ; § 24, *KStG.*). The tax office gives a written notice about the amount of the advance payments, which may be sent at the same time as the assessment notice (§ 101, *EStG.* ; § 24, *KStG.*).

3. *Final Payments.*

The advance payments (paragraph 2) made for an accounting period on the tax due and the amounts collected by direct withholding are credited to the tax assessed for an accounting period, the latter only in so far as they have been withheld from income that has been subjected to assessment. If the tax due exceeds the amounts to be credited, the excess is to be paid as a final liquidation within one month after the deliverance of the assessment notice. If the amounts to be credited exceed the tax due, the difference between this amount and the advance payments must be reimbursed as soon as the assessment has become incontestable (§ 102, *EStG.* ; § 24, *KStG.*).

PART II. — METHOD OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

I. GENERAL PRINCIPLES.

The following may be said concerning the tax liability of foreign enterprises, due regard being paid to the explanations given in Part I.

If a foreign enterprise is carried on by an individual or by partners (whether individuals and or corporations) or by a corporation, and if the individual owner or the individual partners have in Germany neither their domicile nor place of habitual residence, and if a corporation has in Germany neither its seat nor centre of management, then liability to German taxation can only arise in respect of the items of German income enumerated above on pages 104 and 105, paragraphs 1 to 10 (§§ 2, 3, *EStG.*; §§ 2, 3, *KStG.*; for further information, see paragraph 2 following).

II. TAXATION OF CERTAIN ITEMS OF INCOME.

The various classes of income derived by a foreign enterprise are taxed in the following manner :

I. FOREIGN ENTERPRISES HAVING NO PERMANENT ESTABLISHMENT OR AGENT IN GERMANY.

In the case of a foreign enterprise having neither a permanent establishment nor a permanent agent in Germany, the various kinds of income realised by the enterprise in the country are taxable as follows :

(a) *Dividends* (Dividenden).

Dividends, interest, and other income from shares, mining shares and participations in German companies, including shares of the Reichsbank, German colonial companies, mining companies which are legal persons, and private limited companies (*Gesellschaften mit beschränkte Haftung*), are subject to a tax of 10 per cent on the gross income from capital (§ 3, paragraph 2, No. 7, and § 83, paragraph 1, *EStG.*; § 3, paragraphs 1, 2, and § 24, *KStG.*). The term "interest" means here particularly the so-called "construction-interest"—*i.e.*, interest paid to the shareholders for the period extending up to the time when the enterprise is in full operation (§ 215, paragraph 2, *HGB.*). When dividends are paid on shares in a limited liability company (*G.m.b.H.*), the tax is not withheld at source, but is assessed directly against the shareholder on the basis of his declaration. In all other cases, the tax is collected by withholding at the source 10 per cent from the capital return. The deduction is made by the debtor on behalf of the creditor and is remitted to the competent tax office (§§ 85, 86, *EStG.*; § 24, *KStG.*).

(b) *Interest (Zinsen).*

1. There is a liability to taxation under this head only when the income arises from mortgages (*Hypotheken*), land charges (*Grundschulden*) and other claims or rights which are secured on German real estate or by German rights pertaining to real estate. The tax is assessed against the creditor and amounts to 10 per cent (§ 3, paragraph 2, No. 6, and § 60, *EStG.*; § 3, paragraph 2, and § 21, No. 3^d, *KStG.*). Interest charges which are economically connected with this source of income can be deducted therefrom.

Such an economic connection between interest on indebtedness and taxable income may exist in the case of a person obtaining funds for the purpose of acquiring by means of the latter something which will be a source of income. For example, from the income from a mortgage on property situated in Germany which is subject to a restricted tax liability deduction is authorised of the interest of the debt which the person concerned has contracted with a view to obtaining the funds for the granting of the loan which is secured by the mortgage on the German property, if this debt is secured by the mortgage.

The restricted liability to tax hitherto existing in respect of interest on loans which are registered in a German public register or represented by bonds (*Teilschuldverschreibungen*), the debtor of which has its seat or real centre of management in Germany, has ceased to exist. (Law of June 9th, 1930, authorising the Government to modify taxes for the purpose of facilitating and cheapening in credit the German economy, *Reichsgesetzblatt I*, page 187; decree, dated October 16th, 1930, concerning abolition of the withholding of tax from the income from capital, and of the restricted liability to tax on fixed income bearing securities—*Reichsgesetzblatt I*, page 464).

2. Further, there is a liability to tax in respect of income derived from the participation in a German enterprise as a silent partner. A silent partner is a person who has invested capital in an enterprise, this capital becoming part of the property of the owner of the firm, thus not remaining in the joint ownership of both. A silent partner participating in the assets is to be treated for the purposes of income tax as co-partner (Decision of the Reichsfinanzhof of May 1st, 1930, VI.A.235²⁹—*Steuer und Wirtschaft*, 1930, No. 1067).

Such income is liable to a tax of 10 per cent, which is obtained by deduction at the source (§ 3, paragraph 2, No. 8, and §§ 60, 83, paragraph 1, No. 2, *EStG.*; § 3, paragraph 2, § 21, No. 3^d, and § 24, *KStG.*).

(c) *Patent and Copyright Royalties and Other Income from Personal Property.*

Income from leasing or otherwise transferring for a limited period, literary, artistic or industrial copyrights is taxable, provided these rights are registered in a German public register. If, then, an alien having obtained a German patent grants to Germans a licence, which constitutes a quasi-real right of use, he has restricted liability to income tax with regard to the royalties received from Germany (Decision of the Reichsfinanzhof of November 12th, 1930, VI.A.725 and 726/28—*Reichssteuerblatt*, 1931, No. 234). The tax is assessed against the licensor at the usual rates (§ 3, paragraph 2, No. 3, *EStG.*; § 3, paragraph 2, *KStG.*).

(d) *Rents from Real Estate, Mining Royalties and Similar Income.*

Income from leasing or transferring for a limited period real estate situated in Germany (land, buildings and appurtenances thereto), ships which are registered in a ship's register, inheritable building rights (*Erbbaurechte*) and other rights pertaining to German real estate, as well as movable working capital of an enterprise (*bewegliche Betriebsvermögen*), are subject to taxation by direct assessment at the usual rates (§ 3, paragraph 2, No. 3, and § 38, paragraph 1, Nos. 1 and 2, *EStG.*; § 3, paragraph 2, *KStG.*). Income from mining enterprises is regarded

as coming from trade and industry (§ 29, No. 1, *ESTG.*), and a permanent establishment can always be assumed to exist in this case (see further under II).

(e) *Gains from the Purchase and Sale of Real Estate and Securities.*

Profits from transactions involving the sale of German real estate are taxable when the period between the purchase and sale of the object is less than two years, or when the sale actually precedes the purchase in point of time, unless the aggregate profit in one accounting period is less than 1,000 RM., or unless the taxpayer shows that the object which was sold was not purchased for the purpose of selling it at a profit (§ 8, paragraph 2, No. 10, and § 42, *ESTG.*; § 3, paragraph 2, *KStG.*). The tax is assessed against the recipient of the income at the rate of 10 per cent (§ 60, *ESTG.*; § 21, No. 3^d, *KStG.*). Profits from the purchase and sale of securities are not subject to restricted liability to tax unless the requirements set out under B below are fulfilled (§ 3, paragraph 2, No. 2, and § 10, *ESTG.*).

(f) *Income from Trusts.*

Under German tax law, it is immaterial in classifying income, whether the person drawing the income is the owner, usufructuary, lessee, or has some other right to use the property. In German tax law, the real economic owner is liable instead of the formal civil law owner (§ 98, *A.O.*). Trustee relationship (*Treuhandverhältnis*) exists when somebody who, in civil law, functions as the owner of an object to the outside world is, in fact, so bound by the instructions of the beneficiary or *cestui que trust* (*Treugeber*) that, in point of economic fact, the latter has to be regarded as the owner. If a trustee relationship can be proved to exist, the *cestui que trust* is to be treated therefore as the owner. When a foreign enterprise earns income only as trustee for a third person, that third person, and not the foreign undertaking, is normally to be regarded as taxable in respect of the income, provided that the existence of a trustee relationship can be proved. If a foreign enterprise receives German income by the mediation of a German trustee, the foreign enterprise is taxable on its German income in accordance with the provisions set forth under A, without prejudice to the question as to whether the appointment of a trustee is tantamount to the appointment of a permanent agent in Germany, and to the consequent liabilities (see below, under II).

2. FOREIGN ENTERPRISES HAVING A PERMANENT ESTABLISHMENT OR AGENT IN GERMANY.

It is only where the foreign enterprise maintains a permanent establishment or agent in Germany that it is taxable in respect of its income from carrying on a commerce or industry in Germany (§ 3, paragraph 2, No. 2, *ESTG.*; § 3, paragraph 2, *KStG.*). Items of income mentioned in class A that are derived by the German establishment are included in the income of the establishment. In this case, the tax is based on the total of all the relevant income arising in Germany and is assessed on the usual rates to income tax or to corporation income tax. Any tax withheld, by way of deduction from the capital return, from income derived by the branch establishment is, if the total income is assessed, credited against the tax assessed on German income (§ 68, *ESTG.*; § 24, *KStG.*).

The above matters having been dealt with, the rules applicable to the taxation of income from the carrying out of a trade or a business through :

- (1) A permanent establishment ;
- (2) An agent selling out of a stock owned by the foreign enterprise ;
- (3) An agent with power of attorney ;
- (4) A commission agent or broker ;
- (5) A travelling salesman ;

may be set forth as follows :

In cases (1) and (2), the liability to German taxation arises because a permanent establishment (*Betriebsstätte*) is maintained in Germany. According to German law, any fixed local plant or installation (*Anlage oder Einrichtung*) which can be used in carrying on a permanent trade is regarded as an establishment. Apart from the centre of management (*Ort der Leitung*), therefore, the following are regarded as establishments: branches, factories, purchasing and selling offices, offices and any place where business can be carried on by the *entrepreneur* himself or by his partner, his confidential clerk or other permanent representative (§ 11 of the law concerning the financial settlement). The legal form of the German permanent establishment of a foreign enterprise is not decisive. A juridically independent subsidiary corporation is also regarded as a permanent establishment if it forms with a foreign enterprise an economic unit, or if it is controlled by it as regards finance, management and organisation.

In case (3) permanent establishment in Germany can also be assumed if there is a plant used by the authorised agent for carrying on a trade. If this is not so in this case, and in cases 4 and 5, there will be no liability to tax, on the grounds of there being a permanent establishment in Germany; but it remains to be examined to what extent liability to tax is incurred by having a permanent agent (*ständiger Vertreter*) in Germany. An agent is a person who carries out a legal transaction for another person and in his stead, and it is irrelevant with regard to third parties whether he acts in his own name or in the name of his principal. The term "permanent agent" includes an independent business man, for instance, a general agent (*Generalagent*), or other agent, commission agent (*Kommissionär*), forwarding agent (*Spediteur*), or a representative who, it is true, is dependent, but regularly resides in Germany, such as a managing clerk (*Prokurist*), an agent with a full power of attorney (*Handelsbevollmächtigter*) or other employes, or a travelling salesman. A non-recurring representation, or one which only lasts for a short time, does not, however, give rise to tax liability for the foreign enterprise. For example, the transactions of a broker (*Makler*) within the meaning of the German law is not sufficient to give rise to taxation, because it is the essence of his business to undertake the handling of definite transactions for gain on behalf of another without being permanently employed by this other party on a contractual basis. Having regard to these remarks, it would seem that, in case (1), the agent who receives a commission must in principle be regarded as a permanent agent, but not the broker, within the meaning of the German Commercial Code. As for the travelling salesman, it would depend upon the circumstances of the case, which may be constantly differing. Where there is an agent with a power of attorney, however, the existence of a permanent agent must be assumed.

In the double-taxation treaties which have hitherto been concluded by the German Reich, the right to tax income from commerce, industry or other trade of any kind has been granted to the country in the territory of which the enterprise has a permanent establishment, and this applies also to the case when the enterprise extends its activities to the territory of the other State without having a permanent establishment there. The definition of a permanent establishment is fixed in the more recent treaties as "a permanent place of business (*Geschäftseinrichtung*) of the enterprise in which the activities of this enterprise are carried on either wholly or in part". Apart from the seat (*Sitz*) and real centre of management (*Ort der Leitung*) of the enterprise, the following are regarded as permanent establishments: branches, factories, workshops, purchasing and selling establishments, warehouses and other commercial establishments which have the character of a permanent place of business, and also permanent agencies. It is expressly stated that the term "permanent establishment" does not include the maintenance of business relationships merely through a completely independent agent, or the maintenance of a representative (agent), who, although he is constantly employed on behalf of individuals or corporations of one State in the territory of the other State, merely acts as intermediary in effecting business transactions without being empowered to conclude the transactions on behalf of the firm which he represents. In accordance with these provisions, the facts in the cases (3), (4) and (5) might be such that the liability to tax within Germany would not arise.

B. NATIONAL ENTERPRISES.

Contrary to the remarks made under A 1 (b) 2 above, which had reference to the restricted liability to the income and corporation taxes, national enterprises are subject to unrestricted tax liability. The term "National enterprises" covers enterprises belonging to individuals or partners who have their domicile or habitual residence in Germany, or to corporations which have their seat or real centre of management in Germany. In these cases, liability to income tax or corporation income tax extends to the whole income, regardless of whether it is derived abroad or in Germany, and particularly to the income from an establishment situated abroad or from any other operation carried on abroad. As regards the determination of income and the allocation of taxes, see what is said on this subject in Part I, B : "Assessment and Payment of Taxes" (pages 105 to 111).

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

In principle, the German branch establishment or subsidiary company (operating exclusively in Germany) of a foreign enterprise is liable to tax only in respect of income derived from German sources. Wherever possible, the separate calculation of German income forms the basis of taxation. This possibility can only exist, however, in cases in which the German branch has a separate and proper system of book-keeping. The income of the German branch is determined in this case on the basis of the profits shown by the books, which profits, as circumstances may require, will be adjusted according to the provisions of the law.

In spite of the fact, however, that separate accounts are properly kept, it will often not be possible to obtain a separate and reliable computation of the German income. Moreover, there are cases in which a separate computation of the German income is absolutely impossible, because either there is no system of book-keeping at all or the system of book-keeping is unsatisfactory. In all such cases one of the following substitute methods may be employed :

(a) It is possible to take, as a basis for the determination of income, the profits of the German establishment normally earned by German firms of the same or similar nature, which are entirely independent, but at least the normal rate of interest on the capital employed in the German branch. The term " capital " in this connection covers not only invested assets (*Anlage-Kapital*) but also the liquid working assets (*umlaufende Betriebskapital*), and particularly goods, products and stocks (*Waren, Erzeugnisse, Vorräte*). This provision also applies when, in consequence of measures taken by the management, the profits have been apportioned between the German branch and the foreign head office on a different basis (§ 34, paragraph 1, *EStG.* ; § 13, *KStG.*).

(b) The income tax or corporation income tax may be fixed at a lump sum (*Pauschbetrag*), which will be the result of an estimate and usually applies for several years (§ 34, paragraph 2, and § 48, *EStG.* ; § 13, *KStG.*).

It is also possible to employ the methods under (a) and (b) when a separate and reliable computation of the German income is possible.

(c) The German income is computed as a fraction of the total net profit of the enterprise on the basis of factors resulting from those actual business conditions which are of primary importance for the earning of profits.

No special rules, either statutory or administrative, have been laid down for the choice of the factors which are to be employed in ascertaining profits. In practice, the following standards of apportionment are usually employed :

In the case of banks and credit enterprises, and also commercial enterprises, the ratio of gross receipts realised in Germany to the total gross receipts ;

In the case of insurance enterprises, either the preceding standard of apportionment, or the ratio of premium income in Germany to total premium income ;

In the case of other enterprises, the ratio of salaries and wages paid in Germany to the total salaries and wages paid, excluding any directors' percentages (*Tantiemen*) paid out of the total surplus.

Where the above-mentioned factors cannot be ascertained or do not provide a reasonable basis for apportionment, the assessing authorities or fiscal courts of appeal select the factors which are to be employed in determining the part of the profit taxable in Germany according to the circumstances of the particular case.

It is within the discretion of the competent fiscal authority to select the method of assessment, but its decision must depend on what is just and fair.

In the preceding and in the following remarks, the term "permanent establishment" or "branch" (*ständige Niederlassung oder Zweigniederlassung*) covers all those cases in which a foreign enterprise has, in Germany, either a branch or a permanent agent. The term "branch", for the purposes of German tax law, also includes the German subsidiary company (*Tochtergesellschaft*) of a foreign parent company (*Muttergesellschaft*), when both these companies form an economic unit (*wirtschaftliche Einheit*).

(a) METHODS OF ALLOCATION.

1. *Method of Separate Accounting.*

What has just been said above in the beginning of this Part has already shown in a large measure the use of this method.

The income of the branches and subsidiaries is separately determined, when a separate and proper system of book-keeping exists and a separate and reliable computation of the German income is possible, on the basis of the profits shown by the books, and possibly adjusted in accordance with the special provisions of the tax laws. The computation of this profit and the checking of its correctness are made in accordance with the methods above.

2. *Empirical Methods.*

Instead of this profit, the tax officials may take as a basis for taxation purposes, a *presumed profit* equal in amount to that which would have been earned by entirely independent German firms of a like or similar nature, or at least to the normal rate of interest on the capital employed in the German branch or subsidiary. Finally, the tax may be fixed at a lump sum, which is based on an estimate.

3. *Method of Fractional Apportionment.*

If a German branch or a subsidiary company which is equivalent to a branch has no accounts at all, or no separate accounts or no properly kept separate accounts, or if a separate computation of the German income cannot satisfactorily be made, then the fiscal authorities have, in addition to the two methods mentioned under A, the possibility of computing the profits of the enterprise on the basis of the factors obtained from the actual conditions of business which are of predominant importance for the earning of profits. With regard to the ascertainment of the income of the foreign company, reference is made to the remarks indicated above. Foreign corporations must submit with their tax declaration the annual report of the whole enterprise.

4. *Requirements for Selection and Value of the Various Methods.*

A method satisfactory for all cases does not exist. The decision must be taken by the competent authorities on the basis of the facts of each case, having regard to what is fair and right, with the result that certain general principles will gradually be evolved for settling cases of the same or similar nature (see pages 117 and 118). The method mentioned above to assess a profit equal to the presumable one of analogous independent German undertakings, or to the normal rate of interest on the capital invested, can also, in particular cases, achieve reasonable results. In cases such as the one now under discussion, no use has yet been made of the powers granted in the Income Tax Act to fix, as a measure to facilitate taxation, average rates (*Durchschnittssätze*) for income or for the bases of its computation (§ 46, *EStG.*; § 13, *KStG.*) (see below, under section D).]

(b) APPORTIONMENT BETWEEN BRANCH AND PARENT ENTERPRISES.

1. *Apportionment of Gross Profit of Local Branch to Real Centre of Management Abroad.*

The question of ascribing profits to the real centre of management (*Ort der Leitung*) in a foreign country can normally only be of importance when the German income is ascertained as a part of the total income of the foreign enterprise (see "Method of Fractional Apportionment", page 118). As the computation of the part of the total income attributable to Germany will depend primarily upon factors pertaining to the operations of the establishment in Germany (its gross receipts and the salaries and wages it pays), the allocation of the part of the total income which is not claimed for Germany to other eventual permanent establishments, including the real centre of management, is left over to interested foreign tax authorities, where no special treaties have been concluded. The reservation in advance of a certain amount of the entire income to the country in which is situated the real centre of management is unknown in German tax law, nor is it provided for in any of the double-taxation treaties hitherto concluded by Germany.

2. *Apportionment of Interest Charges on Indebtedness of Real Centre of Management to Branch.*

The manner according to which the interest payable on debts of a foreign enterprise will be apportioned between the real centre of management abroad and the branch in Germany depends on which of the methods mentioned above is adopted for the computation of the profits taxable in Germany. If, in accordance with the principles set forth above, a deduction can be made for debt at all, it must be deducted from the part of the income with which the debt is economically connected. If there is no economic connection between the debt and a particular part of the income, it will be distributed among the countries concerned, according to reasonable proportion (for instance, on the basis of the gross income in the individual countries, or on the basis of the assets invested in the individual countries).

3. *Apportionment of Net Profit.*

Apportionment of Net Profit of Branch to Parent in Deficit. — No account can ever be taken of a loss to which the operations of the whole enterprise are subject if the German income has been separately determined or is computed with reference to the profit which would normally have been earned by independent German firms of the same or similar nature. Furthermore, no account will usually be taken of this loss, if the tax

is levied on the basis of a lump sum for several years. On the other hand, the loss will necessarily be taken into account when the German income is fixed as a fraction of the total net profits of the enterprise.

Apportionment of Net Profit of Parent to Branch in Deficit. — This case also depends on the method of computing the profit. If the German income is determined separately, the loss shown by the branch determines the ascertainment of the profit to be assessed in Germany. If a lump sum has been agreed on for several years, as a rule no account will be taken of the loss. If the profits are computed on the basis of a comparison with those of similar enterprises in Germany, or as a fraction of the total net profits of the enterprise, the loss will never be considered.

II. APPLICATION OF THE METHODS OF ALLOCATION IN SPECIFIC CASES.

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

1. *Selling Establishments.*

Local Establishments selling in National Markets.

In the case of enterprises manufacturing or buying abroad and selling in Germany through a permanent establishment, no special methods are, as a rule, employed. The rules set forth above are therefore applicable in general to such cases. Such enterprises are subject to a restricted tax liability on the basis of income derived from German sources. The taxable profits are determined by means of the methods mentioned above.

Local Establishments of Foreign Enterprises selling abroad.

If a foreign enterprise with its real centre of management in one country has a branch in Germany which makes sales in a third State in which the enterprise has no permanent establishment, the income taxable in Germany of such foreign enterprise includes also, as a rule, the profits which the establishment situated in Germany derives from the sales made in a third State.

2. *Manufacturing Establishments.*

With regard to enterprises which manufacture in Germany and sell abroad, a similar practice is followed to that indicated in the case of enterprises manufacturing or buying abroad as well as in Germany (see "selling Establishments" above).

3. *Buying Establishments.*

If a foreign enterprise buying goods or raw materials in Germany with a view to manufacturing or selling them elsewhere has, in this country, no permanent establishment or agent, no restricted tax liability is incurred in Germany on this ground. If, on the contrary, it has a permanent establishment or agent in Germany, the enterprise is subject to a restricted tax liability on the basis of the income derived from the carrying on of commercial or industrial activities in Germany. The rules indicated above in the paragraphs headed "Selling Establishments" are applied *mutatis mutandis*.

4. *Research or Statistical Bureaux: Display Rooms, etc.*

If a foreign enterprise has an establishment in Germany which does not directly engage in profit-making activities, but renders services to the enterprise which contribute indirectly to the realisation of profits (*e.g.*, statistical bureaux, display rooms, etc.) the activities of such establishment or branch equally give rise to tax liability in Germany. For the purpose of determining the taxable profits in Germany, the rules indicated above in the paragraphs headed "Selling Establishments" are applied *mutatis mutandis*.

(b) OTHER KINDS OF ENTERPRISES.

The rules applicable to the allocation of profits of banks and banking companies, insurance companies, transport enterprises, power, light and gas, telephone and telegraph enterprises, mining enterprises, and, in general, all kinds of enterprises, whatever their object, have been explained pages 119 and 120.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

I. GENERAL METHODS OF ALLOCATION.

As German undertakings are taxable in Germany in respect of their total income—that is to say, also in respect of profits earned abroad—no question normally arises of a segregation or apportionment of the income earned in the various countries. Whenever double-taxation treaties concluded by Germany provide for the taxation of income earned by a permanent establishment in the other contracting State by that State, the apportionment is effected by employing *mutatis mutandis* one of the methods discussed above, provided no special agreement has been made with the other State.

II. ALLOCATION OF PROFIT TO REAL CENTRE OF MANAGEMENT WITHIN THE COUNTRY.

Where the real centre of management of a company is in Germany, the German corporation tax is payable on the whole of its income, and consequently there is no question as a rule of separately determining the profits of the real centre of management. Only when double-taxation treaties provide for the taxation in the other contracting State of profits derived from activities carried on therein is it necessary to apportion income between the two countries. The method of apportionment would be fixed in special agreements which, until general principles have been evolved in this field, could be agreed in each case between the supreme fiscal authorities of the interested States; cases of this kind have not yet become practical.

C. HOLDING COMPANIES.

I. NATIONAL HOLDING COMPANY CONTROLLING FOREIGN SUBSIDIARIES.

In the case of German trusts and holding companies which control foreign subsidiaries, the total profits of the entire enterprise are assessed, provided that the two companies form an economic unit. On the other hand, if the German holding company and its foreign subsidiaries do not form an economic unit, the profits earned by the subsidiaries abroad are not in any case assessed to German taxation. The question of computing their profits therefore does not arise.

II. LOCAL SUBSIDIARY COMPANY UNDER THE CONTROL OF A FOREIGN HOLDING COMPANY.

If a German subsidiary is controlled by a foreign holding company, the computation of the German profits is made along the lines laid down (pages 117 *et seq.*), provided the two form an economic unit.

D. DIFFICULTIES AND RECOMMENDATIONS.

1. In general, the method of separate assessment, where it is possible, may be said to give correct results and so be, in practice, not difficult to apply. The disadvantages of this method are, in the first place, that the field over which it can be applied is always somewhat limited, because a separate assessment is not possible in numerous cases, and, secondly, that the method can have unfair results if the fiscal authorities of one of the interested States have occasion to adjust for taxation purposes the results shown by the separate accounting in such a way that these adjustments react on the results of operations in another State. Such adjustments will not be rare when the rate of tax is lower in one State than in another, because the tendency of the taxpayer to throw as much profit as possible into the State which has the lowest tax rate will be reflected in the accounts. If, for instance, the authorities in one State adjust the accounts in their favour and a corresponding adjustment is not made by the fiscal authorities of the other State double taxation can arise to this extent, but, in many cases, the taxpayer cannot complain and must put up with it as it was caused by him.

2. On the other hand, empirical methods (comparable profits, normal rate of interest, "average" rates) offer, from the view-point of the fiscal authorities, the simplest solution. But they do not always operate with sufficient fairness, because these methods always ignore the effect of the special circumstances implied by the combination with a foreign enterprise. Although, on the one hand, this method is very helpful in distributing equally the tax burden, on the other, it cannot always preclude double taxation.

3. It may be said that the method of fractional apportionment (*Verteilung*) is preferable, both from the viewpoint of fairness, which is identical with just taxation, and from the viewpoint of diminishing as much as possible double taxation. This method will always be of importance in practice because, in numerous cases, the separate assessment of income will not be possible. Unquestionably, the ideal, and therefore perhaps the unattainable, goal would be to determine the total profits of the entire enterprise on the basis of uniform law and to divide the total profits on agreed principles. This system, however, could only be employed within an individual State in regard to the division of the tax revenue between the various interested fiscal authorities thereof. In international intercourse, a uniform determination of total profits is not possible, in view of the fact that there is no harmony between the tax legislation of the various countries. It would be possible for each interested State, however, even in carrying out its own internal law, to determine the total profits in accordance with rules of assessment applicable in its case. The adoption of some system of reciprocal fiscal assistance might considerably lessen the difficulty of determining the total profits in the countries in which permanent establishments, other than the real centre of management, are maintained. An agreement regarding the principles of allocation would remain essential. Certain principles of allocation might be evolved in practical experience, as described (pages 117 *et seq.*), but they would probably have to be different for the various categories of enterprises and, in the cases mentioned (pages 120 and 121) experience might lead to the establishing of certain well-defined allocation percentages (*Teilungsquoten*).

Both in our relations with States with which double-taxation agreements exist and with States with which no general arrangements for avoiding double taxation have been concluded, experience has shown that, because of the peculiar nature of the various branches of industry and of the economic relationships, sometimes the one and sometimes the other method is suitable. Whether a comparison between our own experience and that made in other countries will prove that the one or the other method is really preferable can only be judged when we have had an opportunity of reading the other reports.

List of Abbreviations.

A.O. — *Reichsabgabenordnung* (Fundamental Law concerning Taxation).

EStG. — *Einkommensteuergesetz* (Income Tax Law).

HGB. — *Handelsgesetzbuch* (Commercial Code).

KStG. — *Körperschaftsteuergesetz* (Corporation Tax Law).

RGBl and *Reichsgesetzbl.* — *Reichsgesetzblatt, Teil I oder Teil II* (Official Gazette, Part I or Part II).

RM — Reichsmark.

TAX SYSTEM AND ALLOCATION METHODS IN SPAIN

by

Dr. AGUSTIN VINUALES

Professor of Political Economy and Finance at the University of Granada.

PART I. — GENERAL DESCRIPTION OF INCOME TAX SYSTEM

On its main lines, the Spanish system of direct taxation is still based on the 1845 reform which introduced the French tax system into Spain.

As it has developed in Spain, however, the system has become very different from the parallel system in France. As regards the technical methods employed for taxation of large undertakings, Spanish legislation is much more highly developed than that of most other countries on the same subject. Nevertheless, the main features of the old French system persist. On several occasions, attempts have been made to develop this system along the lines followed in other countries; but various factors—and, in particular, the conservative attitude adopted by the Administration—have, luckily for our financial system, hitherto prevented these hasty attempts. This obviated the retrograde movement that would have been inevitable (in view of the very heavy burdens that now weigh upon the Spanish fiscal system) if progress had been attempted in the wrong direction.

It should, however, be noted that the opposition to the introduction of a general tax on income is based solely on the fact that, in Spain, the preliminary conditions which are essential to the success of any such reform are not fulfilled. It is of course realised that the Spanish system of direct taxation is incomplete. It will remain incomplete so long as there is no comprehensive income tax.

Everyone admits that nowadays. Indeed, the taxes in force were systematically based on the notion of *real taxation*, because it was anticipated that a comprehensive income tax would at some future date be superimposed on the existing system and that such a tax would have to be based solely on the principle of personal taxation.

From the standpoint with which we are now concerned, the system of direct taxes at present in force is, as we shall see later, based on the principle of origin, whereas the various suggestions for an income tax show that the notion underlying this reform tends towards the principle of domicile combined with that of nationality.

Spain is still an agricultural country. There are, in round figures, 2½ million agricultural undertakings, almost all of them of an individual character.

There are about 1,000 mining enterprises.

Other industrial and commercial undertakings number 606,000.

The criterion of taxation (*Steuermassstab*) is always the *net product* — that is to say, the difference between the total output of the undertaking and the cost of production.

I. TAX ON INCOME FROM REAL ESTATE.

The land tax on property not employed for building purposes is levied not only on income from the land properly so called, but also on the profits derived from its cultivation. If the land is rented, the landlord and the tenant may agree between themselves as to the proportion of the tax to be borne by each, but from the point of view of the Government there is only one person responsible—namely, the landlord. There are two different forms of this tax—rural and urban. The normal rates are applied in all municipal districts where the new cadastral survey is applied. The rate is 17 per cent *plus* a supplement of 7.50 centimes in respect of urban real property. It is 16 per cent in the case of rural property situated in country districts and the products of the stock-raising industry. In districts where the new cadastral survey is

not yet complete, the tax is distributed, and its rate changes every year, though only slightly. The principal amount of the tax is increased by the addition of 16 centimes in respect of primary education. Personal receipts are given at the time of collection. Any landlord not resident in the area of the municipality in which the real property is situated is required to inform the Administration of the name and address of a person who will represent him for fiscal purposes.

2. INCOME FROM MINES.

With the exception of quarries, the working of minerals is always subject to a Government concession. The holder of the concession, whether a Spaniard or a foreigner, must, each year, pay direct to the revenue authorities a charge known as the area tax, since it is levied on each hectare of the concession. The rate varies according to the minerals extracted, but it is always very light. The proportional mining tax is based on the commercial value of the products extracted. It amounts to 3 per cent of that value. It is paid quarterly direct to the revenue authorities.

At first sight, proportional tax on mines seems to constitute an exception in our system, as it is based on the gross output and not on the net product. But if we consider that most of the mining undertakings belong to companies, and are liable as such to the special corporations tax, we shall readily understand that the exception is of no practical importance.

3. THE "PATENTE" TAX.

When the French *patente* tax was introduced into Spain, companies were taxed like physical persons. Gradually, in the course of history, the taxation of companies was divorced from the general system. The latter has, on the whole, remained the only form of taxation on industrial and commercial undertakings belonging to physical persons, whereas a special system for the taxation of great companies by shares has grown up with a very complicated, very highly developed technique.

The *patente* tax is highly specialised. There are thousands of items in the rates for this tax. In the case of industry, the rates are based on the power and kind of machines and equipment; in the case of trade, many external factors are taken into account in deciding the taxpayer's category. For most of the rate categories the tax on turnover plays a supplementary part. In the case of trade, where the specification could not be carried far enough, the taxpayers of a district form associations of an administrative character and these determine the individual shares.

It has been stated above that there are 606,000 industrial and commercial undertakings, including mining enterprises. This number includes enterprises belonging to individuals: 581,000 ordinary partnerships and 10,000 limited partnerships. There are only 5,500 companies with share capital: corporations, limited partnerships with share capital, or limited liability companies.

The individual undertakings are, for the most part, small or medium in size.

These small undertakings are scattered throughout a territory of half a million square kilometres whose population is not yet twenty-five millions and whose financial administration is centralised. It may thus easily be seen that the introduction of a general income tax is neither possible nor reasonable. Account must also be taken of the special psychology of the majority of Spaniards, who are anxious that their obligations towards the Government should be definitely fixed.

These facts have compelled the legislator to adapt the special tax on companies so as to make possible a systematic concordance between the basis of taxation and the *patente* tax. Any Spanish legislator who ignored this highly important historical requirement would destroy the fundamental basis of our system of direct taxation, and the system would accordingly fall into chaos. That is why, notwithstanding the technical subtleties of the law on the taxation of companies, the net product still remains the basis of taxation.

4. TAX ON INCOME FROM WORK AND PERSONAL PROPERTY.

The "Contribución sobre las utilidades de la Riqueza mobiliaria" (tax on income from movable property) was set up in Spain by *the Act of March 27th, 1900*.

The tax includes three schedules, as follows :

- (1) Income from work ;
- (2) Income from capital, including dividends ;
- (3) Companies' profits.

This arrangement is clearly borrowed from that of Italian taxation, but its analogy with foreign systems ceases at this point. The content of the Act is purely and simply Spanish. With the exception of the tax on interest on the public debt, to which recourse has been had for the liquidation of the colonial wars, the Act is, in some sort, a codification of traditional Spanish law.

A. TAX ON COMPANIES.

An exemption from the taxation of profits was accorded to insurance companies which were taxed on the sum total of their premiums, mining companies subject to the payment of mining royalties, and companies whose sole object was the possession and exploitation of immovable property subject to the land tax.

The taxation of companies includes several taxes. That part of the net product which is allocated to interest on bonds is subject to the special tax on such interest. That part of the net product which goes to the directors of the undertaking comes under the tax on directors' percentages (*tantièmes*). Finally, that part of the net product which is allocated to the undertaking itself pays two different taxes. One of these is levied on the income of the company, the other on the portion of that income which is distributed to shareholders in the form of dividends. The combined effect of these two taxes is that the portion of the income which is allocated to shareholders tends to be more heavily taxed than the portion retained in the company's reserve funds. To appreciate the historical reasons for this double taxation we must remember that great Spanish companies have not directed their policy towards the constitution of large reserve funds. That was not, however, the only reason for which the system was introduced. It may be well to stress this point. There are formal differences between the tax on profits and the tax on the dividend paid by Spanish companies and by foreign companies operating in Spain. The former is levied on the company as such, the latter on the shareholder or, in general, the member of the company, although the company is always required to deduct the tax at the moment when it pays the shareholder his dividend. Ultimately, however, as an essential part of the Spanish system, both these taxes are considered as part of one and the same tax—namely, the tax on the *net product*.

When the 1924 reform was introduced and an exemption from tax was granted in respect of profits on business done abroad by Spanish companies, the Military Dictatorship, in the Legislative Decree of December 20th, 1924, treated the tax on profits separately from the tax.

on dividends. The former, in accordance with the real property principle, was based on origin, the latter was considered from the personal standpoint and was based on residence. This innovation led to such protests that the Military Dictatorship, which was then at the height of its power, had to yield, and a new Legislative Decree of June 30th, 1925, abolished the new system and re-established the fundamental unity of the two taxes. This change of attitude was only thinly veiled by the arguments put forward in the explanatory statement.

It has been said above that the need to link up taxes on companies and the *patente* tax induced the legislator to make the net product the basis of taxation in the case of companies also. This same need explains the introduction of *minimum payments* in taxes on companies. In the case of real taxes, the obligation to pay the tax remains as a general rule even when there is no real profit. This common feature of real taxes on the product and on property has been called by theorists the "property character of taxes on the product". But taxes on companies are all based on real income and would not be paid if that income should fail. To meet this case, and to maintain the analogy between taxes on companies and the *patente*, the Spanish law fixes a minimum amount payable by companies. This minimum is proportional to the company's real capital—*i.e.*, the total made up by the share subscriptions of members of the company and the effective reserve funds.

In the 1918 plan of reform, the Government proposed that Parliament should limit the application of taxes on companies to large companies only, but Parliament decided to the contrary and included also ordinary and limited partnerships. As far as it could, the Government opposed this extension, and agreement was reached on the following compromise formula : companies of a personal character are liable in accordance with the system of taxes on companies but, in their case, the minimum payment is not calculated on the basis of the capital. The minimum payment is represented by the *patente*.

In Spain, we therefore apply the following system for the taxation of industrial and commercial undertakings :

Commercial or industrial undertakings belonging to physical persons are subject to the *patente* tax irrespective of nationality. A receipt is given at the time of collection.

Ordinary and limited partnerships and share companies with a capital of not more than one million pesetas are subject to the tax on profits, and the amount of that tax cannot in any case be less than that of the *patente* tax. In practice, the *patente* tax is collected and the tax on profits is levied only on the difference, if any.

Share companies, limited partnerships with share capital and limited liability companies are subject to the tax on profits if their capital exceeds one million pesetas. The amount of the tax cannot in any case be less than 3 per 1,000 of the paid-up capital *plus* reserve funds.

In the case of a foreign undertaking doing business in Spain or a Spanish undertaking doing business abroad, the Spanish tax on the profits made by the undertaking is levied only on that part which is proportional to the business done in Spain. The fractional method is always applied. As the minimum payment is not a tax on the capital, but the limit below which the tax on profits cannot fall, this minimum payment is always assessed according to the relative figure for the business done by the company in Spain.

Basis of Assessment—Rates.

Taxes on companies have the following bases :

The tax levied on interest on bonds is based on the contractual interest thereof. This tax is progressive, and varies in proportion to the rate of interest concerned. It is between 6 and 7 per cent.

The tax on directors' fees is based on the sums received, whatever the form of the contract, and whether the remuneration is fixed or variable. The rate of this tax is 15 per cent.

Tax on a company's income is based on the *accrued value*. It is proportional to the ratio between the income and the effective capital (share subscriptions *plus* reserve funds). Finally,

the tax on dividends and earnings of capital is based on the amount actually received. It is proportional to the ratio between the dividend and the amount of paid-up capital *plus* accumulated reserve funds.

All these taxes are payable *ex post facto*, that is to say, after the incomes on which they are assessed have actually been produced. The legal formula is that the State is a co-creditor with the person to whom the income is to be paid.

Nationality of Companies.

This system applies irrespective of nationality. The only differentiation made is that Spanish companies operating abroad pay a specific national charge, to which reference will be made later.

The assessment of the tax is always based on the return made by the undertaking and is in two stages—provisional and final. For the former, the administration is bound to accept the return made. The final assessment is arrived at after the inspection department has examined the accounts of the undertaking. The tax is paid direct. The Statute of Limitations applies after five years as from the date on which the liability is incurred. During that period, the amount of any payment may be revised, but, when the final assessment has been fixed, a special departmental order issued by the Minister is required before any extraordinary revision can be made.

Companies are bound to submit certified copies of their balance-sheets and an abstract from the profit and loss account. If there is a report to the shareholders, a copy must also be submitted. Extracts from the records, the audited accounts and declarations of dividend must also be supplied.

Treaties on taxation also impose on foreign companies operating in Spain certain supplementary obligations to which reference might usefully be made.

As the fractional method of apportionment is employed in Spain, these treaties provide that the taxable fraction may be ascertained on the basis of assets, sales, receipts, expenditure, profits and other economic factors, or on a combination of two or more of these factors. Before these treaties were concluded, the Administration considered declarations of these facts to be voluntary on the part of the companies. In practice, companies always do their best to supply the Committee of Experts with the fullest possible information as a basis for their calculations. The treaties mentioned have made it compulsory for companies to supply this information. In case of refusal the company loses its right of appeal. In practice, the Spanish Administration shows great anxiety to spare companies all unnecessary work and expense. The information may be supplied in French, Portuguese, Italian, German, English or Spanish. The Administration—particularly in the case of foreign companies—enquires as little as possible into anything of a secret nature relating to manufacturing processes or the administration of the undertaking, particularly as regards production costs and contracts for sale or purchase.

NOTE ON THE HISTORY OF LEGISLATION REGARDING COMPANIES.

For the allocation of profits, the Act adopted the system of separate accounting in its most unmixed form. The *Provisional Regulation of March 30th, 1900*, restricted appreciably the application of the tax on profits in the sense that it exempted from the tax manufacturing companies which remained subject to the payment of the *patente* tax. The *Act of December 31st, 1905*, substituted for the idea of corporations that of companies with share capital, consequently limited partnerships with share capital were thereafter subject to the tax on profits. Finally, the *Act of December 28th, 1908*, subjected industrial companies to the tax on profits.

The system of separate accounting did not fail to produce in Spain the effects which would appear to be inevitable under this method of allocation.

During the first phase, the Spanish Administration was inspired by the benevolent sentiments manifested in the *Definitive Regulation of September 18th, 1906*. In this regulation it was provided

that interest paid to a foreign parent company by its Spanish branch should be deducted from profits earned in Spain. The unity of the taxation of dividends and profits is maintained in the Regulation in the strictest possible manner, but as regards the tax on interest an exception has been allowed to the extent that the interest on bonds secured by mortgages was attributed to the State in which the mortgaged property was situated. This exception has given rise to some scandalous frauds.

The results of the system of allocation based on separate accounting gave rise to a violent reaction in public opinion, in particular in the circles immediately concerned. Under pressure of public opinion, the Government submitted a Bill to Parliament according to which all companies subject to the tax on profits had to pay the *patente* tax as a minimum contribution. Parliament rejected the Bill and substituted for it a minimum payment on the basis of capital. The reaction against the system of separate accounting is to be seen in full force as early as the *Act of December 30th, 1910*.

The capital of foreign concerns in Spain must be evaluated under this law as follows :

(a) The material factors of production have to be evaluated by experts of the Administration ;

(b) Commercial operations must be divided between Spain and other countries in proportion to the *giro* (business turnover), which has been defined as the total of sales and expenditure, either in cash or on credit.

The *Royal Decree of April 25th, 1911*, was enacted for the application of the above Act.

This Decree is of special significance in the history of Spanish fiscal legislation.

In it will be found, defined clearly for the first time, the principle of economic unity. For subsidiary companies constituted as Spanish companies, the Decree set up the system which is still in force. The Decree is also remarkable because it provides for the exemption of foreign steamship companies, a system which ten years later was developed considerably, following the example of the United States of America.

The *Royal Orders of December 20th, 1927, and February 18th, 1930*, interpret the text of the Decree in question in the sense that, if a company undertakes navigation operations in addition to other business in Spain, the income from such operations is always exempted from Spanish taxation.

An exchange of notes on April 16th, 1930, and June 10th, 1930, resulted in an agreement on this basis between Spain and the United States of America.

The Act and the Decrees relative to the allocation of profits constitute, regarded as a whole, a complete negation of the whole system of separate accounting. This was the work of Parliament acting under the pressure of public opinion.

The change was brusque. The experts who were entrusted with drawing up the draft Decree and with the application of the Act and the Decree pointed out to the Government that the proportional system introduced by the Act would work satisfactorily only on condition that the allocation constituted an act distinct from the assessment of the tax, and that this act was entrusted to a special organisation outside the control of all rigid regulations, the composition of which organisation should allow of the question of allocation being brought into the sphere of men of business, without any fiscal preoccupations. As a result of these representations on the part of the experts, the Government arranged for a detailed consideration of the question.

The law of April 29th, 1920 (which was based on the Bills of October 22nd, 1918, and November 13th, 1919), abolished the system of separate accounting, but certain provisions of the new Act were so strict that the Government prolonged discussion of the matter until Parliament had granted the authorisation necessary to modify these provisions in special international treaties. Recourse was had to this indirect method because of the general spirit manifested by Parliament in these questions. The necessary authorisations are contained in the *Act of July 26th, 1922*.

The treaties in question are dated as follows :

With Great Britain, June 27th, 1924 ;

With France, August 5th, 1926 ;

With Italy, November 28th, 1927.

These treaties include the most-favoured-nation clause. In principle, Spanish Governments have been unanimous in rejecting this clause in conventions concerned with double taxation ; but the Spanish Government which concluded the treaty with Great Britain was advised by the competent departments of the Ministry of Finance that the Anglo-Spanish treaty was inadequate, and there was some hope of remedying its defects by such corrections as it might be possible to include in other treaties. Any remaining strictness in the Act was finally abrogated by the *Royal Decree of November 26th, 1929*.

The *Legislative Decree of December 20th, 1924*, established the regime for companies operating abroad. This Decree was not based on the principle of the fundamental identity of the tax on profits

and the tax on dividends. Nevertheless, this unity was in practice re-established by the *Legislative Decree of June 30th, 1925*.

The reform in question represents a most liberal solution, in comparison with foreign legislative systems, of the problem of Spanish companies operating outside our frontiers as regards the taxation of their profits, their dividends and the interest on their bonds. But the new system left untouched the question of the dividends of foreign subsidiaries of Spanish companies, and also the question of the interest on the bonds of such subsidiary companies. This question was of great importance, since the unfortunate results of Article 2 of the Act of 1900 had been aggravated by the *Royal Order of June 23rd, 1923*, which was maintained by the Supreme Court of Justice in its *decision of May 27th, 1924*.

According to this decision, the dividends and interest forming part of the profits attributable to Spain were liable respectively to the tax on dividends or to the tax on interest, even if such revenues were derived from abroad and were paid abroad by a person resident abroad. The *Royal Decree of November 13th, 1930*, solved these problems to the extent possible within the system set up by the Act. It was provided in the Decree that the interest and the dividends collected by a Spanish company operating abroad should be exempt from Spanish taxation if, by decision of the jury, such income was part of the foreign business of the company in question.

As regards salaries and wages, the *Legislative Decree of December 15th, 1927*, simplified the tariff and introduced uniform principles of taxation to the extent possible in view of the political and social position of Spain.

A special *instruction* was published on *May 8th, 1928*, for the application of the Legislative Decree in question.

B. TAX ON SECURITIES.

Government Bonds and Local Municipal Bonds.

Government loans abroad are free of tax under the affidavit system. The Dictatorship exempted from taxation some of the internal Government loans. In the case of other Government loans, the rate is 20 per cent and collection is effected by deduction at the source, without any exception on the grounds of nationality, residence or domicile. Interest on corporation loans is taxed at the same rate as private bonds and credits. The rate varies from 6 to 7.5 per cent according to the nominal rate of the interest concerned. This tax also is deducted at the source. No differentiation is made on grounds of nationality, residence or domicile.

Shares and Bonds of Spanish Companies and of Foreign Companies doing Business in Spain.

Dividends are subject to a tax the rate of which varies with the amount of the dividend as compared with the fraction of the capital represented by the share. Capital is considered to consist of the amount actually paid up together with a proportional part of the company's reserve fund. The rate varies from 5.5 to 17.25 per cent.

Interest on bonds is subject to taxation at the same rate as interest on local municipal bonds. Both the tax on dividends and the tax on interest must be deducted at the source by the company itself, and the latter must send the Administration a certificate to that effect. After verifying the facts, the Administration issues receipts for the amounts collected. The company is given 1 per cent of the amount of the tax as payment for these services.

Foreign companies operating in Spain are subject to the tax on dividends and on interest on their bonds only in proportion to the amount of business they do in Spain. As regards the companies' profits, the ratio is fixed by the Committee of Experts. Exactly the same ratio is applied in the case of interest on the companies' bonds. In principle, the same figure is also applied to the dividends; but if consideration is given to the companies' reserve funds, then account is taken of the comparative rates, or ratios, in force at the time when the profits were accumulated. For this calculation, the rule is that the sums last accumulated are those first distributed.

Securities of Foreign Governments and Foreign Companies not doing Business in Spain.

The tax on interest on foreign governmental and municipal bonds and the bonds of foreign companies not operating in Spain, and on the dividends of such companies when these items of income are taxable under Article 2 of the law to which we shall refer later in greater detail, is collected by means of a deduction which must be made by the bank or person effecting the payment in Spain.

Directors' Percentages.

In accordance with the principle that taxes on profits, dividends, interest on bonds and directors' percentages are only special forms of a single tax based on the *net product*, the percentages collected by the directors of a foreign undertaking doing business in Spain are liable to Spanish taxes in the proportion indicated by the figure which the Committee of Experts fixes to determine the fraction of the profits earned in Spain by the undertaking in question.

C. PATENT AND COPYRIGHT ROYALTIES.

As will be seen later, Spanish law exempts these incomes from taxation for so long as the rights from which they arise belong to the author. In practice, therefore, only patents and certain authors' rights which are generally exploited by commercial companies are subject to this tax. This exemption in favour of the author was doubtless the chief reason for the systematic classification of these royalties in the Spanish law as income derived from personal capital. If these rights are collected by foreigners not resident in Spain, and if they do not belong to a commercial or industrial undertaking doing business in Spain, they will come under Article 2 of the Act — that is to say, they will in practice be taxed only if they are paid in Spain or if the payment is made by a person residing in Spain, or in any case if the income is of Spanish origin. Hitherto the question has been solely of academic interest, as all taxes on the productions of the mind are so unpopular in Spain that the Administration avoids them as far as possible.

D. PRIVATE SALARIES AND WAGES.

Salaries up to 1,500 pesetas per year are exempt from tax. In the case of wages the minimum is 3,250 pesetas per year. The contractor or employer is bound to deduct the tax and to make a declaration in respect of his employees and workmen. For this work he is paid 1 per cent of the amount of the tax. At the time of collection, a receipt is issued in the name of the person who is obliged to make the deduction.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

I. DEFINITION OF "FOREIGN ENTERPRISE".

The commercial code does not define the nationality of commercial companies. Other sources of Spanish commercial law define the notion of a Spanish company according to the legislators' aim in each particular case. The Fiscal Law defines Spanish companies solely for the purposes of direct taxation. Article IV of the Royal Decree of 1911 says: "Companies which are constituted in accordance with Spanish laws and which have their legal domicile in Spain shall be considered as Spanish companies". Consequently, any other enterprise is foreign.

II. GENERAL PRINCIPLES.

The fundamental principle at the basis of Spanish legislation on the subject is that of taxation at the source. This concept has, in existing literature on the subject, lost its original precision, particularly since the problems of double taxation have acquired the exceptional importance which they have nowadays. It might be said that in recent days the concept of *origin* has lost its clear significance and expresses no more than the contrary of the principle of domicile. Spanish legislation is entirely free from any uncertainty in this connection. For the Spanish legislator, *origin* always means the territory on which the profit has been made or where the income, generally speaking, has its source. Thus the origin of a dividend is not in the country where the company was formed, incorporated or registered, where it has its headquarters or centre of management, but rather the country where were made the profits which are distributed as dividends. The same principle is true of interest and other similar forms of income.

The historical reason for the exceptions to the general principle will be found in Article 2 of the Act of 1900, which article contradicts the entire system laid down in the Act and the general principles upon which it is based, without itself conforming to any principle.

This provision, which is at first sight odd in the extreme, owes its origin to the somewhat dramatic circumstances connected with the liquidation of the Spanish colonial wars. From the capitalist point of view, the relations of Spain with foreign countries had, until the period of the colonial wars, been such as were natural for a country economically penetrated by large-scale international capitalism; but at the time when Spain lost her colonial empire, Spanish interests in the former Spanish colonies were from then on external to Spain, which became by reason of such interests "a creditor country". The legislator of 1900 had to solve the problem of the taxation of dividends and interest coming from such sources and collected in the mother country. The following is the solution as given in Article 2 of the Act:

"Any physical or juridical person, national or foreign, is subject to this taxation as a result of any income which he may derive on Spanish territory or which may be paid to him on such territory or outside such territory by persons or entities domiciled or residing on such territory, or by any income which may be paid to him on Spanish territory, even if the debtor person or entity is resident abroad."

Article 2 has been interpreted by the Administration and by legal theory in a wide sense, in so much that it has been laid down :

(1) That it should be considered that payments were effected in Spain if the beneficiary of the income resided within the country. (Decision of the Supreme Court of Justice of October 29th, 1926 ; Royal Order of April 8th, 1925 ; Decision of the Supreme Court of Justice of May 5th, 1929.)

(2) That income derived from abroad and paid abroad to a foreign undertaking was nevertheless subject to Spanish taxation if such income formed part of the Spanish business of the undertaking in question. (Royal Order of July 23rd, 1923 ; Decision of the Supreme Court of Justice of May 27th, 1925.)

The obvious inference is that the principle of domicile is completely ignored in the article. Three other principles are applied in the article and are given equal importance with no systematic connection between them.

There has been no lack of understanding in Spain of the confusion which Article 2 of the Act introduces into all its economy. The Spanish expert chosen by the Government for the Geneva Conference of 1928 was formally ordered to emphasise the inconsistency of our system from this point of view, and recently the Minister of Finance wrote as follows in the introduction to the Royal Decree of November 13th, 1930 :

“ The Act establishing a tax on income from movable capital adopted the three following criteria : the source of the income, the domicile or residence of the person or entity effecting the payment, and the place of such payment. These criteria have not been combined into a system, but each one of them is, in case of necessity, sufficient to make taxation legal without reference to either of the others.

“ The Minister of Finance who authorised the reform, together with the competent departments of the Administration, has not failed to understand the serious defects of the system in question ; but the existing formula is necessary for practical reasons, the importance of which has been held to be decisive in the fearful difficulties arising from the liquidation of the collapse of the Spanish colonial empire.”

This consciousness of the serious defects in Spanish legislation is also shown in a series of practical provisions the object of which was to correct such defects. It may be taken for granted that once a normal constitutional regime is re-established in Spain, it will not be long before an Act is passed removing any part which may still remain of Article 2 in question.

The most serious practical difficulty in the article was double taxation. But, as a matter of fact, Spaniards only had to bear the burden, and the provision was enacted at a moment when almost everyone in Spain was ready for any sacrifice that might be thought necessary to meet the national obligations.

III. TAXATION OF CERTAIN KINDS OF INCOME.

(a) *Dividends.*

The tax on dividends is, in principle, collected by deduction at the source. Consequently, the dividends of Spanish enterprises which do not do business abroad are taxed *in toto* in Spain, whatever may be the nationality, domicile or residence of the receiver of such dividends. Such is the fundamental principle of the Act.

From this principle, the following corollary is obtained. If the enterprise which pays the dividends does business both in Spain and abroad, its dividends are taxed in Spain only to an

extent proportionate to the operations carried on in the country itself. This rule is subject to the two following limitations in the case of enterprises of Spanish nationality. First limitation—one-third at least of the total sum distributed in the form of dividends is, in all events, subject to Spanish taxation. Second limitation—the dividends of "holding" companies pure and simple and of investment trusts, simple or mixed, are taxed in their entirety in Spain.

The actual working of Article 2 of the Act in question has the following effect which is contrary to the fundamental principle of the Act.

If a person resident abroad receives a dividend from a foreign company which does not do business in Spain, under conditions such that the juridical act of payment takes place within that country or is effected by a person resident in Spain, such income is taxable under Spanish legislation. In actual practice the Administration does not exact the tax, and the question is therefore of purely academic interest.

(b) *Interest.*

A distinction should be made between interest on public and interest on private debts.

Interest on Spanish public external debt under the affidavit system is exempt from Spanish taxation. Interest on public internal debt not exempted from taxation by the law is taxed by deduction at the source, whatever may be the nationality, domicile or residence of the receiving person.

The principle mentioned above in the case of dividends is applicable also to the interest paid by industrial and commercial enterprises. In the case of a company which does business only in Spain, all the interest on its shares is subject to Spanish taxation. If the company does business both in Spain and abroad, part only of the interest on its shares is taxed in Spain—*i.e.*, that part which is proportional to the importance of the company's business in Spain.

It should be added that Article 2 of the Act subjects to taxation interest on other private debts if such interest is paid by a person resident in Spain or if the legal act of payment takes place on Spanish territory. As a general rule these conditions are fulfilled if the debtor is resident in Spain. In practice the question is of purely academic interest.

(c) *Patent and Copyright Royalties and Other Income from Personal Property.*

Income of this kind is taxable according to the *principle of origin*. It is subject to the special regime set up by the Act of April 29th, 1920, under which the normal 15 per cent tax is exacted only when the rights in question do not belong to the author in person. Widows and children are taxed at the reduced rate of 2 per cent.

If the enterprise which possesses the copyrights and patents in question carries on business in Spain under the conditions laid down in the question, income from such copyrights and patents remains included in the total profits, which are taxable in Spain in proportion to the business turnover of the enterprise within the country.

Spanish administrative practice has hitherto been most liberal in its application of the Act—*e.g.*, no attempt has been made hitherto to tax translation rights collected by foreign authors, despite the considerable importance of such rights. This attitude on the part of the Administration is due to the fact that, according to the Act, the rate of taxation of such income must be fixed by the Minister of Finance on the principle of reciprocity. In actual practice the rate has not been fixed and in these circumstances the Administration has not collected the tax.

(d) *Rents from Real Estate, Mining Royalties and Similar Income.*

Income from real estate, with the exception of mines, is subject to the territorial tax. The *principle of origin* is applicable in this case. Royalties from leased mines are considered as movable income. For such income the principle of Spanish legislation is that of multiple taxation—*i.e.*, the income is taxed successively on each occasion when it fulfils the conditions provided by the law for the levying of a tax. Since the reform of 1920, this principle has been subject on several occasions to exceptions in virtue of the contrary principle *non bis in idem*, especially in the case where the owner of the mine is a company the dividends of which are subject to taxation. In such a case the above-mentioned tax on royalties from leased mines is not exacted.

(e) *Profits from the Purchase and Sale of Real Estate and Securities.*

It was stated at the beginning of the report that there is no general income tax in Spain. Profits from trade in real estate and securities are, generally speaking, taxed under the registration and stamp duties (*derechos reales*). The special company tax is applicable to profits made on the purchase and sale of goods which contribute to the total profits of a company. The Act provides that the increment in value of goods included in the assets of the company is not considered as profit to the extent to which such increment in value has not been realised by means of a sale, or does not in any other way affect the profit and loss account of the company.

Spanish legislation does not attach such profit either to the place of purchase or to the place of sale. It confines itself to economic realities and attributes profits to the place where the establishment is situated which does the business from which the profit is derived. For instance, if a foreign company which has no permanent establishment in Spain buys a property which it later sells at a profit, the profit is not liable to direct taxation in Spain. Similarly, if a foreign bank which has no branch in Spain buys securities on the Madrid Stock Exchange which it later sells at a profit on the Barcelona Exchange, such profit is not directly taxable by the Spanish Administration. Generally speaking, the Spanish Administration taxes the profits of a purchase or sale in common with the whole of the business of which the transaction in question is a part, and makes no attempt to sacrifice this principle of practical attribution to any purely formal rule. A foreign company which has an establishment in Spain and makes profits as the result of a transaction connected with the operation of such establishment, will be taxable through such establishment even if purchases or sales have been effected abroad. For example, the Spanish branch of a foreign bank buys securities in Mexico and sells them in New York at a profit. Since this transaction is part of the business turnover of the bank, the resulting profit is taxable as being the profits of the Spanish establishment.

(f) *Income from Trusts.*

The Spanish civil code is very severe on trust institutions, but does not specifically consider the "trust" as it exists in British or American law. As a general income tax does not exist in Spain, in the event of the fiduciary being a company subjected to the special company tax double taxation is not involved, because the Administration deducts from the total profit the sums received by the trustee. Theoretically speaking—the case has never arisen in practice—it might happen that under Article 2 of the Act, and contrary to the fundamental principle of the Act itself, the income from a foreign source paid to a trustee resident abroad would be taxable in Spain if the said trustee were resident in Spain. This also is a purely academic question.

(g) *Income from the carrying on of a Trade or Business through:*

(1) *A Commission Agent or Broker.* — The existence of an independent agent does not, in Spain, involve an obligation to pay taxes on the enterprise which engages him. The agent is subject to the *patente* tax in the case of a physical person, or to the special company tax in the case of a company. Spanish law covers a special case which is most important in practice—namely, the case of a foreign company carrying on operations in Spain through the medium of another company, whether Spanish or not, which acts as a clearing house in Spain for orders for various foreign enterprises. This case is somewhat frequent in Spain. Several foreign enterprises, whether controlled or not by another enterprise, agree to found a company in Spain whose operations are carried on in the form of sales on commission. In fact, it is only a matter of an organ of the community of interests or cartel formed by these interests. The law prescribes that in such cases the special committee of experts, which will be referred to further on, shall decide whether such a society is in fact a non-autonomous organisation of the foreign enterprise. The principle in the law remains—namely, that, if between the foreign enterprise and the business carried on in Spain there intervenes a truly autonomous agent, not only from the strictly legal point of view but also from the point of view of economic realities, the operations carried out through the medium of such an agent do not give rise to an obligation to pay the tax.

Thus both Spanish law and practice are in harmony with the results obtained by the Fiscal Committee. It may be said that this agreement is even greater than is desirable in the sense that the principle which is still left open in the work of the Committee has not yet been touched upon by Spanish jurisprudence. Some time ago, the question was raised in connection with an accusation of fraud brought by a Spanish enterprise against a foreign enterprise, but, before any administrative procedure was instituted, the business in question was made the subject of a monopoly and the proceedings were consequently stopped.

(2) *A Travelling Salesman.* — According to Spanish law, a travelling salesman involves no tax liability for the firm that employs him.

(3) *An Agent with Power of Attorney.* — In principle, an agent with power of attorney always involves liability to pay taxes for the company which engages him.

The Decree of 1911 contains an important provision from this point of view, the object of which is probably to raise the difficult question of procedure involved in the proof of the existence of an agent's power of attorney. Under this provision the existence of such power of attorney is always presumed on proof of the carrying out of a legal act the validity of which demands the existence of such power of attorney according to Spanish law.

(4) *An Agent selling out of Stock owned by the Foreign Enterprise.* — If the stock of goods is located in Spain, the enterprise is subject to taxation in the country.

Some years ago, this question was raised in connection with a case of some importance, but an essential modification in the legal regulations for the trade in question prevented the theoretical question from being thrashed out.

(5) *A Permanent Establishment of any Kind.* — Besides the cases mentioned under (3) and (4) above, Spanish law subjects to taxation any enterprise which possesses in one or more provinces of the country "offices, factories, workshops, installations, warehouses and stocks of goods, shops, or other similar establishments; branches . . ." (revised text of Article 4, tariff 3, second provision, first paragraph).

The third paragraph of the same provision exempts from taxation foreign steamship companies which carry on no other business in Spain, and requires that installations, the most important category, have the character of fixity.

As is shown later in further detail, if the enterprise carries on operations in Spain and abroad, a proportion only of its profits is subject to taxation.

It should be emphasised that the fundamental principle of Spanish law is that operations carried on by companies in Spain determine the extent of their obligations in respect of taxation. From this principle may be deduced the corollary that all enterprises which maintain in Spain an agent with power of attorney, or a permanent establishment, are, in virtue of the existence of such agent or establishment, compelled to pay taxes in Spain; but the volume of the operations of the enterprise in Spain from the fiscal point of view is not limited to operations carried on through the medium of the agent or the permanent establishment. All operations undertaken by the enterprise in question within the country are taken into account.

This solution, which is clearly deducible from the principle of the law, would have been imposed by practical necessity, since many foreign enterprises formally mention the greater proportion of their commercial operations as being directly regulated by the central office.

From the same principle is deducible another most interesting corollary—namely, that, in Spanish law, the control of business done plays no part (except in so far as will be mentioned later), and consequently the business operations controlled by a permanent establishment of the enterprise situated in Spain are, from the fiscal point of view, left entirely out of account if the operations have been carried on elsewhere.

It may be recalled that the proportion of total profits which is fixed for taxing the profits of the permanent establishment in Spain is also employed for taxing the dividends and interest paid by the foreign company at its head office abroad.

B. NATIONAL ENTERPRISES.

Until the reform of 1924, Spanish companies were subjected in Spain to a tax on their profits as a whole. In the preliminary draft of the Fundamental Reform of 1920 there was a proposal to exempt from taxation a part of the profit of Spanish companies proportionate to the volume of their business abroad.

One might be tempted to believe at first sight that this was no more than the application to Spanish companies of the general principle of the law governing foreign companies, which law subjects to taxation in Spain only a part of the total profits of the enterprise proportionate to the operations carried on by the company in the country.

This, however, is not so. The principle of the Act is that the Spanish company is subject to taxation on its profits as a whole, but, *in order to avoid double taxation*, the fiscal administration of the Spanish State abandons its rights to the extent to which a foreign State in the territory of which a Spanish enterprise is carrying on business would, under Spanish law, have the right to tax such enterprise.

When the preliminary studies for the new draft were under consideration, the question was raised whether the Spanish State had to renounce a portion of taxation equal to the amount collected by the foreign State if the rate applied by the latter was not higher than the Spanish rate, or if it would be preferable to deduct from the profits a part proportionate to the volume of business carried on abroad. The latter solution was adopted because of the advantage which it possessed of putting the Spanish company on the same footing from the point of view of taxation as the competing enterprise of a foreign State. The fundamental principle, however, remains that exemption is always subject to the *sine qua non* condition that the Spanish company should be subject abroad to a direct tax (in the sense of Spanish law) on its profits or on its capital, and that the Spanish enterprise remains subject to taxation in Spain up to at least one-third of its profits or its capital whatever may be the proportionate importance of its business abroad.

This part of the preliminary draft for the reform of 1920 was not carried. The "National Cabinet" Government decided, in a council of Ministers, to postpone this part of the reform because of the budgetary deficit. It nevertheless ordered the competent department to suppress this part of the preliminary draft in such a way that it could, at a later date, be incorporated in the text of the Act without affecting its purport. This incorporation was effected by the Legislative Decree of December 20th, 1924, drawn up by the Military Dictatorship.

(a) *Dividends* and (b) *Interest*.

Mention has already been made of the inconsistency which Article 2 of the Act of 1900 introduced into the system of direct taxation in Spain, and it has been pointed out that the inconveniences of the article fall in practice upon Spaniards. It has also been stated that an effort is being made to eliminate all traces of this provision.

Since decisions of the courts have held that the dividends and interest collected by Spanish companies should be subject to taxation as if they were paid in Spain, the companies have remained subject to taxation for all dividends and interest on the transferable securities in their possession, even in cases where certain revenues have been taxed at the source. Such revenues were taxed a second time as profit of the Spanish company, and a third time as dividends distributed by the company or as interest paid on its bonds.

The Legislative Decree of 1924, despite its decisive importance from the point of view of avoiding the double taxation of the profits of Spanish companies carrying on business abroad, has only partly solved the question of the tax on dividends and interest.

According to its provisions, the dividends of Spanish companies carrying on business abroad were exempt from Spanish taxation to an amount proportionate to the operations carried on outside the country, with the reservation that at least one-third of the dividends were subject to taxation in Spain.

But the question of the taxation of the dividends and interest collected by a Spanish company possessing shares in other companies remained without solution. It has already been stated that the principle of Spanish law is that an income should be subject to taxation each time that it comes under the conditions provided for in the law for the application of a tax. An exception was made in favour of the dividends of companies taxed on their profits, in the sense that 80 per cent of such dividends were deducted from the profits of the company that received them, the 20 per cent being considered as administrative charges. But, if a Spanish company received dividends or interest from a foreign company not carrying on operations within the country, such dividends and interest were subject to the tax on dividends and interest, even if they had already been subject to taxation in the country of origin.

The Decree of November 13th, 1930, to some extent removes this inconsistency in our legislation. The dividends and interest collected by a Spanish company carrying on operations abroad which, according to the decision of the committee of experts of the Ministry of Finance, form part of the company's business operations abroad are not subject to Spanish taxation.

The importance of this provision is considerable. Formerly the Spanish company which controlled one or more subsidiary foreign companies had to pay the tax on all the dividends collected by the companies controlled by it, even in the case when such income had already been taxed in the country of origin.

This charge has now disappeared. The interpretation of the Act concerning the taxation of these dividends, in so far as they are profits of the company which collects them, is still open to doubt. However important the question may be from the legal point of view, it is of no importance in practice because, when the committee of experts fixes the comparative ratio of the foreign business of a Spanish company, it counts as such the profits represented by the dividends of the foreign companies controlled by the Spanish company.

All Spanish experts are convinced that the existing system is incomplete in the sense that the dividends of foreign companies which are not effectively controlled by the Spanish

company, and the interest on the bonds of the foreign companies held by the Spanish company, are subject to Spanish taxation, save in the exceptional case of the securities in question forming part of the foreign business which is dependent on the Spanish company—as, for example, the portfolio of the branch of a bank. Nevertheless, the Decree of 1930 marks a great advance in the pure and simple application of the fundamental principle of the law of taxation at source.

(c) *Copyright Royalties, Royalties on Patents and Other Similar Forms of Income.*

Such income, if a part of the business of a Spanish company abroad, is not subject in Spain to the tax on profits. If the Spanish company carries on no business abroad, and if the beneficiary is a physical person, such income is taxable under Article 2 of the Act already quoted, subject to the exemption enjoyed by the author himself and the reduction of rates in favour of the widow and children of the author.

(d) *Income from Immovable Property situated Abroad.*

Such income is not subject to taxation in Spain. Income from mines on lease situated abroad is not subject to taxation in Spain, except in so far as Article 2 of the Act applies; but it is nevertheless exempt if the beneficiary is a company which is subject in Spain to the tax on dividends, as a result of the exceptional application of the principle *non bis in idem*.

(e) *Profits from the Sale and Purchase of Immovable Property and Securities.*

Such income is subject to taxation in Spain if it forms part of the profits of a company. In such case, they are either subject to or exempt from taxation, according as the transaction is or is not part of the company's business transactions in Spain, as has been pointed out in connection with foreign companies.

(f) *Income from a Trust.*

The same system as for foreign companies.

(g) *Income from a Business or Industry.*

Spanish law applies to a Spanish company carrying on operations abroad the same system as to foreign companies carrying on business in Spain. The replies, therefore, given to numbers 1 to 5 for the latter companies apply *mutatis mutandis* to the former companies.

Methods of Checking.

The Spanish Administration has never hitherto had to deal with any case which might involve a special control of income derived from abroad by Spanish companies, since the documents of the companies have been sufficient to assure the Administration that no profit has been hidden; but, if the Spanish Administration met with any resistance from a company in its endeavour satisfactorily to establish the sum total and the source of its income, there can be no doubt that, in such a case, it would apply the Legislative Decree of 1924, which entitles the committee of experts to refuse, if necessary, to fix the ratio concerning the foreign business of the company, at the same time informing the Government of its refusal. This in no way prejudices the responsibility, assumed by the company in the case of resistance or refusal, to produce the documents demanded by the Administration. The committee of experts is bound in all cases to fix a ratio of profits in such a way that the resistance or refusal of the taxable party does not result in loss to the Spanish Exchequer. It will easily be understood that such a situation might be very serious for the company and, in practice, the committee of experts has hitherto been given all facilities by Spanish companies.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

(a) BOOK-KEEPING AND ACCOUNTING REQUIREMENT.

In regard to accounting, the fiscal laws and regulations always refer to the commercial code. The latter provides that traders must at least keep the following books :

- (1) Balance-sheet and accounts book ;
- (2) Journal ;
- (3) Ledger ;
- (4) Copy letter and telegram book ;
- (5) Any other books the keeping of which is obligatory under certain special laws.

Companies must also keep a book in which decisions taken by general meetings or by the board of directors are recorded. The commercial code lays down rules for keeping these books in accordance with the usual commercial practice.

Under question 5 we must make special mention of the law on insurance companies.

(b) METHODS OF ALLOCATION.

Until the reform of 1920, branches of foreign concerns subject to company taxation—there was no question of the *patente* tax—were, in general, taxed according to their book-keeping. The system constituted a real scandal for Spanish companies. The pressure exercised by the ruling classes and by Parliament on successive Governments was such that, despite the resistance of the Government and of the Administration in general, a very severe system was ultimately devised for foreign companies.

Gradually successive Governments wrung from Parliament either certain attenuations of the system or the authorisation to conclude treaties which, while guaranteeing Spanish companies against the application to foreign companies of what was virtually a system of exemption, safeguarded the interests of the Spanish Exchequer, while respecting the legitimate rights of foreign concerns.

This system was elaborated by the departments concerned over a period of ten years. Advice was sought from certain authorities on high finance, and from important manufacturers, accountants and high officials of the Central Administration of Finances.

This study of the subject led to an agreement to eliminate the system of taxation according to accounts. The main reasons for this change were the following :

(a) Clearly, in any system of taxation the principle of which is taxation according to capacity to pay, the method of separate accounting introduces an element of the irrational, in view of the fact that it is possible, and even probable, that a concern which is working at a loss may be taxed on its profits. The reform conceded by the Spanish Government and proposed

to the experts has admitted the fundamental, absolute principle that such a case should not be allowed to arise, except in connection with the minimum payments on capital.

(b) Another reason played a very important part in the establishment of the Spanish system. When the reform was under consideration, all the experts were agreed in recognising that the system to be established should be such as to satisfy the requirements of the "100 per cent test". This means that, supposing that the system were to be of universal application, it should never yield, for all countries together, a basis for total taxation different from the total income or capital of the concern. This condition is of particular importance in Spain, because real profits are always taxed in Spain *a posteriori*. It was at once clear that, if each branch of a concern was to be treated as an independent concern, there could be no offset as between profits and losses, and the result would be that an undertaking would be taxed on profits higher than its actual profits. A study was made of all Spanish companies with branches in the provinces which applied special fiscal systems. The enquiry covered a period of three years. It showed that the method of treating branches as separate establishments instead of treating concerns as a whole increased the basis of taxation by 16 per cent. The tax being progressive, the final result exceeded the normal rate by 21 per cent.

(c) The accounts of a concern can show the income of one of the concern's branches only if they are kept according to special rules, which is not the case with the majority of foreign concerns established in Spain, the accounts of which, being drawn up on different although legitimate lines, are not such as to satisfy the requirements of the Spanish Exchequer. If book-keeping was to be retained as the basis of taxation, the experts held that it would be necessary to infringe the liberty of business concerns to a very considerable extent. The most delicate point was the verification of prices quoted by the parent company to branches or subsidiary corporations. With the exception of a small number of articles for which a wide market is obtainable, it is difficult to verify prices without resorting to what might be called arbitrary methods. From the practical point of view, for instance, how could the Administration control cost prices in the case of factories turning out hundreds of different articles situated in another country, or perhaps even in another continent?

(d) From the technical point of view, the problem cannot be solved by the system of taxation according to accounts. Take the case of a concern which manufactures in one country articles which it sells in another country through the medium of its branches. Suppose that manufacturing costs have been established with all possible accuracy and in the strictest sense of the phrase—*i.e.*, with no account of profits. Profits always introduce an element of risk. They are only known after the sale has been effected. The distribution of such profits between manufacture and sale demands the application of some general rule. Accounts can be kept in accordance with such a general rule, but the rule itself can never depend on the accounting system. It follows from the above that to combine the problem of net costs with that of the allocation of profits results only, from the scientific point of view, in a useless complication of the method to be followed, and that the result is the same if the method employed is that of direct distribution according to the rule without the application of which it would be useless to enquire into net costs.

(e) Even the strictest regulation of private enterprises by the Administration would not enable it to determine whether the branch or the subsidiary company is managed in absolute economic independence—*i.e.*, from the point of view of the interests of the branch or subsidiary company itself—or whether it is treated as a part of the concern as a whole from the point of view of the general interests of the concern as a whole.

Heads of undertakings consulted on this point were unanimously of opinion that, if the branch of an enterprise, or even an enterprise as a whole, was carried on for the profit of a

community of interests of which it formed part, the profit shown on the books, even if established with all necessary accuracy, would not show the real importance of the economic part played by the branch or by the enterprise in the group considered as a whole. They drew the attention of the Government to the fact that in such groupings of business interests it was rare to find any statement of profits accounted for in the distribution of the total profits of the whole group of enterprises. This point of view was later confirmed by the development of the *Konzern*. It follows that, if it be desired to tax branches or subsidiary companies, in accordance with their real economic importance, methods must be adopted similar to those which are in use for the distribution of profits in those groups of undertakings.

(f) The existence of these *Konzerne* and their international operations renders nugatory, in a whole series of cases, according to our experts, the system of separate accounting. Take, for instance, a Consortium "X". The various enterprises included in this group draw up their accounts in identical lines determined in advance. This accounting system has to show clearly the profits made by each of the interested enterprises. But according to other articles of the contract, all these profits are pooled and finally redistributed, in proportion to the share-capital issued. If, in all these many cases, the number and importance of which are continually increasing, the Administration were to confine itself to the accounting, it would take as a basis of taxation not the profits actually made by the company, but profits no longer in the possession of the company—that is to say, a purely imaginary figure.

There was no other logical solution except to apply to any undertaking forming part of a *Konzern* the same criterion of allocation as that used for the internal distribution. And this is what Spanish legislation has done.

(g) All cases of dumping have been specially considered from this point of view. If undertakings in a given country compel their branches or subsidiary companies abroad to sell at small profits, or even at a loss, in order to increase internal prices, the real rôle and importance of such branches and subsidiary companies abroad will be completely lost sight of if it is judged by the small profits made or by the losses incurred.

For these reasons, Spanish legislation has been led to establish the existing system, which consists in distributing the total profits of the undertaking between the various countries in which the operations are carried on.

The experts admitted that there were a certain number of cases in which the profits of a branch might be approximately determined without recourse to arbitrary measures, and that the formula adopted in such cases might be sufficiently wide to take such cases into account. The problem has been solved in the cases in question by distributing the total profits of the undertaking in proportion to the partial profits of the various branches. In such cases, the system of division and of direct taxation give the same result. This group of cases includes principally commercial undertakings and, in particular, deposit banks. It is in this sphere that the system of separate book-keeping plays a most important part in the Spanish regime—a part which was even greater before the conclusion of the treaty with Great Britain dated June 27th, 1924.

As regards the question of subsidiary companies, the experts were not long in coming to the conclusion that, if the operations carried on by a concern through the medium of a non-autonomous agent involved taxation under Spanish law, it was clear that, from the economic point of view, there could be no agent less autonomous than a subsidiary company. There have been so many cases of fraudulent evasion that public opinion in the country was unanimous on this point. Jurists whose opinion carried weight with the Spanish Parliament urged that the law should precisely define cases in which the Administration should be empowered to declare that a company independent from the point of view of legal theory was in fact no more

than a branch of some other company or concern. The existing system is therefore characterised in the two following ways :

(i) A declaration on the part of the Administration that a given company is no more than a branch of some other company or concern is not obligatory but optional. In point of fact, the Administration never takes a decision of this nature if the subsidiary company is, in its management, substantially independent from the economic point of view.

(ii) The power referred to above is limited, and the Administration can proceed to make use of it only in cases provided for by Spanish law. The decision of the Administration on the point may be contested by the taxpayer apart from any assessment of taxation. In legal theory there can be no assessment of taxation so long as the decision of the Administration has not been confirmed. The system works perfectly well. The only criticism might be that there is an idea among Spanish business men that the Administration is too moderate in the use made of its powers. In practice I do not know a single case in which a decision of the Administration on this point has been contested by the interested enterprise. The Administration's decisions have invariably been accepted.

A few words may be said concerning the methods of distributing the income and capital of the concern between its various branches and sub-offices. Spanish legislation contains no specific ruling on this point. It has created a committee of experts, consisting of two representatives of high finance, the Director-General of Public Receipts, the Director-General of Stamp and Registration taxes, the head of the Department of Special Taxes on Companies, and an expert of recognised competence. The Act calls this committee a "jury", because it can make decisions only on economic facts and not on the law of taxation. The decisions of the jury are in the following form: "The business turnover in Spain of the . . . undertaking is estimated at . . . per cent of the total business turnover of the concern, taking an average over a given period". The period in question is three years, but the law concedes the enterprise the right of demanding the revision of the percentage fixed if, during the period, any important change takes place in the business carried on in Spain. The State enjoys a similar right, but has up to now made no use of it.

According to Spanish administrative conceptions, the functions of public administration are as a general rule reserved for Spaniards. Consequently the members of the "jury" chosen from the representatives of high finance cannot be foreigners. This rule involves a distinction in the procedure for carrying out the decisions of the jury according as the concern dealt with is national or foreign. It is admitted in Spanish law that Spanish undertakings are completely safeguarded by the jury, whose decisions in this case are made immediately operative by the Minister of Finance before the undertaking concerned knows what percentage has been fixed. On the contrary, in the case of a foreign undertaking, the administration communicates the jury's decision to the taxpayer. If the taxpayer refuses to agree, he is at liberty to put forward his reasons for such refusal. The Minister of Finance collects any information which he thinks desirable, and submits the question to the Council of Ministers. The members of the jury are forbidden to communicate any information on the subject. The reason for this is that what they know of an undertaking must not be communicated to anyone. This precaution is indispensable, since, in view of the prestige which they enjoy, the members of the jury receive information of the utmost importance concerning business houses in Spain.

It is thus easy to form an idea of the general position of the law and of Spanish practice as regards the problem of allocation of profits. In the presence of each case not included in one of the exceptions which will be referred to later, the first question which arises is the following: "Is a branch or subsidiary company managed with absolute economic independence or is its management subordinate to the interests of the general group of which the branch or subsidiary company is part?"

I. *Method of Separate Accounting.*

If the branch or subsidiary company is carried on in such a way as to make the maximum profit for itself, the committee of experts takes, as a basis for the percentage which it must compute, the real profits determined according to the definition given in Spanish law, which definition is common both to national and to foreign companies. If, for instance, the branch of a foreign undertaking shows a profit of 2.5 million pesetas, and if the total profits of the undertaking over the same period are, in application of the same definition of Spanish law, 33 million French francs, which, at the rate of exchange at the date on which the balance-sheet was drawn up, is equivalent to 10 million pesetas, the committee of experts will fix the ratio for such undertaking at 25 per cent. In other words, 25 per cent of the total profits of the undertaking will be taxable in Spain, which gives 2.5 million pesetas as the basis for taxation in Spain. In the case of a subsidiary company formed as a Spanish company, the administration will deal with it as with any Spanish company.

The verification of the enterprise's book-keeping in Spain is carried out under the same conditions as for national undertakings. Balance-sheets, statements of accounts and of the position of the parent company must be certified by authorised representatives of the company, whose signatures must be legally authenticated in the usual form. A large number of foreign undertakings accompany their accounts by certificates delivered by expert accountants in their own country. The committee of experts attaches great importance to the amounts assessed by the fiscal administrations in the countries to which the parent companies belong. It goes without saying that the committee of experts always takes account of the different manner in which the term "profits" is defined in the laws and regulations of the various countries.

If the committee of experts is unanimously convinced that the branch or subsidiary company is administered under conditions of complete economic autonomy, but that its accounting methods are not such as to give sufficient indication of the profits made by it in Spain, it has recourse to indirect methods also called "empirical methods". But the main point kept in view by the Spanish Administration is always the profits effectively realised in Spain by the branch or subsidiary company in question.

There is a series of very interesting cases in which, although the branch is administered under conditions of complete economic independence and keeps satisfactory accounts, the Spanish Administration takes no notice of such accounts. Such is the case of a large number of manufacturing and selling undertakings where the application of the method of separate accounting involves the determination of production costs in the widest sense of the word—*i.e.*, including the profits of manufacture. As has been said above, Spanish practice is founded on a well-known principle of political economy, according to which the problem in question, although well determined, is not susceptible of any practical solution. Only in exceptional cases can any adequate approximation be arrived at. In such cases, the method of the Spanish administration is to seek to distinguish the manufacturing profit from the sale profit, without losing itself in the sphere of production costs. These methods are referred to later (pages 154 and 155).

The allocation of sale profit between Spain and other countries is therefore carried out on the basis of the respective volume of business, either purely and simply, or in combination with one other or several other factors, in such a way that account is taken of the special situation of the various national markets with which the undertaking is concerned. The fact of taking into consideration the various situations of the national markets is most important in Spain, as, in view of the special situation of Spanish economy, the various phases of the Spanish economic cycle are, generally speaking, behind those of other countries.

The system of taxation according to separate accounts is equally inapplicable in Spain in the case of insurance companies, and also of deposit banks when the parent company belongs to one of the countries with which Spain has concluded a double taxation treaty. It will be

sufficient to observe here that these cases represent concessions made by the Spanish Government as the result of demands formulated by certain foreign undertakings established in the country, either directly or through the medium of their respective Governments.

These demands would be difficult to understand if account were not taken of the time at which they were formulated—*i.e.*, at the period of the fundamental reform in Spanish legislation which took place at the moment when the flood of economic nationalism was reaching its maximum. There was no relation between these two aspects of Spanish economy, and this is clearly shown by the fact that the provisions of a protectionist character which Parliament inserted in the revised Act have not been applied, since various Governments merely waited for this trace of nationalism to disappear from the text of the Act. But the coincidence in question did not fail to provoke a certain amount of alarm among foreign enterprises, which asked the Spanish Government for guarantees, which were given on the advice of the experts in view of the fact that the spirit of the Act, the intentions of the Government, and the principles followed by the committee of experts, were considerably more favourable to foreign undertakings than the actual guarantees which they demanded. Only in the case of fire insurance companies is the limitation contained in the Act, although very elastic, susceptible of prejudicing the interests of the Spanish Treasury.

The experts drew the attention of the Government to this point, but it was held that the sacrifice was not of such a kind as to prevent foreign undertakings long established in Spain from being given the guarantees which they demanded.

Finally, we will do no more than mention here a general limitation of the principle of separate accounting which will be treated at greater length (page 153.)

Spanish legislation does not permit the taxation of an undertaking carried on at a loss or without profits, even where its branch, or Spanish subsidiary company administered with complete economic independence and possessing an absolutely satisfactory accounting system, makes considerable profits. Similarly, the profit in Spain can never be fixed over 90 per cent, the minimum figure fixed for the centre of management being to our knowledge 10 per cent. We can, at this point, raise and solve questions of some importance in the general problem of the allocation of profits—namely, what there is in common between the method generally known as “separate accounting” and the Spanish method, and what the characteristics are which distinguish the two methods.

The common extent of application of the two methods is both extended and important. When the Spanish method is applicable, the resulting basic assessment is always identical with that which would be obtained by the method of separate accounting. The taxpayer will therefore have to pay the same sum by one or the other method—a fact which, in matters of taxation, is not without importance.

The similarity between the two methods goes no further. From the formal point of view, Spanish law always makes it obligatory to determine a comparative ratio or percentage. On the other hand, in the method of separate accounting there is no place for such a ratio. This is no mere formal difference.

It may be asked why Spanish law always demands a comparative ratio despite the fact that for each series of cases the result is the same whatever may be the total profits of the undertaking, since the arithmetical operations involved are confined to dividing and multiplying by the same number. The answer to this question will lead us to the root of the problem. In Spanish law, the principle of capacity to pay is essential and without exception; but the capacity to pay of an undertaking can be deduced only from the sum total liable to taxation, which can be known only from the general accounts. It is precisely for this reason that Spanish law does not allow the Administration to tax the branch of an undertaking without knowing the fiscal capacity of the undertaking itself.

In actual fact, if a business is being carried on at a loss, whatever may be the importance of the profits realised in Spain, as shown from the book-keeping of the branch or subsidiary

company, the law does not allow the taxation of such profits. There are, of course, a limited number of such cases, but Spanish law goes much further on the path of equity laid down by the principle of capacity to pay. If the undertaking cited in the example given above has made in all a profit of no more than 7.5 million francs—that is to say, a figure equal to the profits made in Spain—our legislation does not permit us to tax this sum as a whole, and if the undertaking is carrying on, either in its country of origin or in another country, business to an amount equal or perhaps several times as large as the figure of its Spanish turnover, our law forbids the Administration to tax more than the half or even a smaller fraction of the profit proportional to the relative importance of the business turnover. This is the deep-seated reason for the difference between the two methods.

We are at the moment in a position to determine strictly the sufficient and necessary conditions under which, always according to Spanish law, the comparative ratio can be established according to the separate accounting of the subsidiary company or branch in such a way as to obtain the same results as would be obtained by the method of separate accounting.

These conditions are two in number: (1) the autonomy of the branch must be complete and (2) the tax on this part of the profits must be proportionate to the fiscal capacity of the undertaking. The two other conditions (namely, the existence of adequate accounting, and the fact that the treaty in force must not be contrary to the application of the method) are no more than purely formal conditions which do not follow from the general principle.

2. *Empirical and Fractional Apportionment Methods.*

If the Spanish Administration (in the case of a subsidiary company) or the committee of experts (in the case of a branch or sub-office) becomes cognisant of the fact that such establishments are not administered in an altogether autonomous fashion but in the interests of the group of which they are part—in other words, if there is an economic unity the general interest of which constitutes the rule according to which the Spanish establishment is managed—the allocation of profits is carried out on the basis of the real facts. In the case of a subsidiary company, the officials of the Administration make the necessary declaration and if such declaration is accepted, the committee of experts endeavours to determine the relative importance of the subsidiary company in question in the *Konzern* as a whole. In the case of a branch or sub-office, this preliminary declaration is unnecessary in view of the fact that, from the legal point of view, there is no reason against supposing the existence of an economic unity.

The determination of the relative importance of the Spanish establishment in the undertaking as a whole has increased the existing prestige in Spain of the committee of experts.

Given the nature of the problem which in such cases is raised before the committee of experts, it will readily be understood that the special circumstances of each undertaking determine the choice of the method to be followed. In point of fact there is not and cannot be any formula or rule of general application. Excellent as such rules might be in certain cases, they would give absurd results if they were applied under different conditions. But, in its assessments, the committee of experts follows certain general criteria of which the most important are the following.

At the outset the "jury" raises this question: Is the Spanish establishment part of a *Konzern* founded upon a community of interests, the consequences of which would be pooling of profits and their ultimate distribution according to certain contractual rules? If such is the case (a situation uncommon enough in the past, but which, as rationalisation progresses, becomes more and more frequent), the committee of experts invites the legal representatives of the undertaking to inform it of the contractual rules for distribution of profits. At the outset it always makes the formal declaration that the undertaking is not bound to furnish information if it does not think that it should communicate such information to the experts. The declaration made by the representatives of the undertaking is always kept secret and not the slightest

trace of such revelations will be found in the relevant files. Moreover the experts who compose the committee are in general so well informed that they know these rules before they ask the representatives of the undertaking what they are. We know of only a single case in which the information requested was refused. In this case, as the result of further instructions, the information in question was sent under cover to the committee of experts, which sent it back without opening it. As a matter of fact it did not need to do so.

After taking cognisance of the rules for the distribution of profits, the committee of experts proceeds to allocate the profits by a strict application of such rules. To our knowledge this operation has hitherto led to no complaints.

If the undertaking is not part of a *Konzern* of this nature, the jury itself draws up a plan of distribution as equitable as possible. The experts act in the same spirit as business men who would have to proceed in practice to the distribution of profits. With this end in view, the jury asks itself the following question: Are the operations of the Spanish establishment of the same kind as those of foreign establishments of the same enterprise?

(a) If the Spanish establishment carries on operations similar to those of other establishments of the foreign company, the relative importance of the Spanish establishment is determined according to the importance of the operations carried on. The problem is thus reduced to the determination of the economic facts which will enable the importance of such operations to be measured. The choice varies according to the nature of the business done. In the case of a manufacturing undertaking where the fixed capital is preponderant, the most important consideration is the real assets. Almost always other factors are also taken into consideration, such as wages, raw materials, the frequency of services rendered by the undertaking, expenses, rent, sales, etc. If, on the contrary, the undertaking in question deals with sales or other similar operations in which the liquid capital plays a preponderant part, it is almost always the business turnover which serves as the basis for valuation at the same time as one or more of the factors referred to above. It has been said above that the economic cycle in Spain does not synchronise with that abroad. Account is taken of this difference in all cases where it exercises any appreciable influence on the business of the undertaking in question.

As a general rule, the facts which serve as a measure of the relative importance of the economic operations of the undertaking within and without the country are clearly indicated by the very nature of the undertaking. Nevertheless difficulties arise in certain cases. The procedure is then the following: the parties concerned are requested to discuss their situation with the experts of the jury. If need be, the jury, which has extended powers, appeals to independent experts. If the facts in question conform to the conditions required for the application of the method, recourse is had to mathematical statistics in order to determine the exact value of the facts which are proposed as a measure of the company's business operations. We will consider this procedure in further detail under (b).

(b) The greatest difficulties which confront the jury are those which arise in connection with undertakings which have establishments in Spain whose operations are different from those of other establishments of the same undertaking situated abroad. The most frequent case of this nature is that of undertakings which have their manufacturing establishments abroad and whose Spanish establishments are confined to selling the goods produced by the factories in question, and *vice versa*. In the general introduction to the statement of the Spanish system, it has been shown that this system almost invariably excludes the question of production costs which it regards as an expedient almost always useless and valueless. The problem therefore arises in the following manner: what is the respective economic importance of manufacture and sale for the undertaking as a whole? The immense variety of cases submitted to our jury may be classed *grosso modo* in two main groups. First, cases where manufacture and sale, although part of the same undertaking, are nevertheless divided between various establishments which have no special connection. As we shall state in greater detail (pages 154 and 155)

a typical case of this nature in Spain is that of undertakings which buy certain famous brands of sherry, and handle the production and sale on all the markets in the world. The case of mining companies should also be cited. Whenever manufacture and sale are carried on by different undertakings it is possible as a general rule to determine for a given quantity of products the profit of production for a given period (in general, three consecutive years); if the same method is applied in the case of sales it is possible to discover the relation between the profit on production and profit on sale for the quantity in question (physical volume) of products. This proportional figure is then applied to establish the allocation of profits in the case under consideration.

If often happens that the method thus applied is very accurate. There are certain branches of commerce where in practice a certain rate of commission has been established which includes certain expenses connected with sales. It then becomes necessary to determine the part of the risk and expense which falls upon the producer. If the risk is negligible the method is applied with complete strictness and thus the profit on manufacture and the profit on sale are accurately delimited.

The second series of cases which is becoming more frequent every day both as regards the number and importance of the undertakings concerned (such is the general trend of present-day economic development), includes undertakings which manufacture and sell articles through the medium of establishments which carry on only one of these two operations. In such cases, the jury has before it a problem similar to that of the distribution of the profit of a *Konzern* with a vertical centralised organisation including sales. The methods employed by the jury are in all respects analogous to those employed in commercial practice. It was with precisely these cases in mind that Spanish legislation recognised the necessity of appointing on the jury well-known Spanish financiers and other experts with a wide experience of business. When these experts have studied a particular case and made a preliminary attempt to find the fairest formula for its solution, they invite the representatives of the undertaking either to appear in person before the jury or, at their choice, to address a written report to the jury. The experts on the jury then discuss with these representatives the formula which is proposed. It is very seldom that they fail to come to an agreement. If any divergence of views arises, an appeal is made to independent experts. Every endeavour is made to treat directly with them, in the absence of representatives of the undertaking, in order to prevent third parties obtaining more information than is necessary as regards the position of the undertaking. In most cases, it is found possible to settle the question by the employment of mathematical statistics. Such use of statistics differs in general appreciably from the methods of certain American experts. Without pretending to cover all cases, we might say that, generally speaking, an attempt is made to discover the mathematical functions which will fairly represent profits, taking as independent variables the economic factors whose significance is doubtful. Then a calculation is made of the probability of the coefficient of regression relating to the doubtful series. A factor is always rejected if its probability does not exceed the ratio 50 : 1.

Finally, for the sake of completeness, I will refer to a very small number of cases where, up to the present, it has not been possible to settle differences of opinion. This is the case with two or three foreign undertakings whose manufacturing establishments are all in Spain and which sell abroad. Their representatives always confront the jury with the following argument which is worthy of a place on the humorous page of a paper: "We sell to the foreigner; it is therefore from the foreigner that our profits come, and not from Spain, where we have only expenses".

3. *Requirements for Selection and Value of the Various Methods.*

The method of fixing a comparative ratio referred to as the "Spanish method" is considered the best:

We have just shown above in what cases the Spanish Administration has recourse to different methods. Except in the very rare cases where there are insufficient data to

allow of a direct valuation, the jury never employs the methods which are called "empirical", if it is right to consider as such (which would appear to be the correct interpretation) those measures which allow of determining profits by a procedure unconnected with accounting. In this way, "empirical" methods would be employed *instead of* accounting methods. Such is not the procedure of the Spanish Administration. When the Administration proceeds to distribute profits according to the data supplied by the series of economic facts determined, it does not in its calculations take into account any supposed accounting profit. This latter is enquired into by the Spanish experts only in the case of absolute economic independence on the part of the Spanish establishment, and for all cases accounting methods are, as we have said, on the basis of the calculation in question, with the exceptions enumerated above which are not founded on any principles and are no more than concessions granted to foreign undertakings which have been established for a long time in Spain.

According to Spanish law, the jury must proceed to calculate profits in all cases in which an undertaking does not keep its accounts in conformity with the provisions of the commercial code. For this purpose, the committee of experts has elaborated empirical methods of evaluation, all of which are founded on one or more of the two following principles: (1) the undertaking in question is compared with other similar undertakings; (2) an attempt is made to determine profits indirectly by means of their probable relation with other known economic factors (*e.g.*, capital, volume of production, energy expended, raw and other materials employed, wages, sales, receipts, expenses, goods forwarded by land or by sea). The probable relation between profits and all these factors is established, account being taken of the experience acquired in previous years for the same undertaking, and of any changes which may be known to the jury to have occurred. Sometimes the two methods are combined which, generally speaking, allows of a more correct evaluation in the sense that this combination of methods allows the state of the market to be taken into consideration, but these empirical methods frequently applied to Spanish companies have to our knowledge been applied to a foreign company on only one occasion, namely in the case of a banks (see page 156).

The jury always fixes a comparative percentage. If there is no doubt that, in its management, the Spanish establishment enjoys absolute economic independence, the jury will take real profits as the basis of its valuation. If, on the contrary, no such independence exists, the Spanish experts endeavour to find an equitable method of distributing the total profits between the head office and the branch or subsidiary company.

(c) APPORTIONMENT BETWEEN BRANCH AND PARENT ENTERPRISE.

1. *Apportionment of Gross Profits of Local Branch to Real Centre of Management Abroad.*

So far as we are aware, Spanish practice always attributes a proportion of profits to the real head office of the management. This practice springs directly from the definition given in Spanish law of a permanent establishment. It also rests on the principle of the fundamental equality between a Spanish undertaking operating abroad and a foreign undertaking operating in Spain.

The ratio assigned to the head office is drawn up by the experts, taking account of the importance of the part played by the management in the business in question. The extreme cases which are within our knowledge show very considerable differences in this connection. If the management exercises no more than a certain control, so that the branches are under their own management and enjoy a large measure of autonomy, the ratio is about 10 per cent.

This ratio increases according as the part played by the central management becomes more important, reaching nearly half the total profits when the business of the company is such that its success depends in all essentials on the efficiency of the management. This is the case, not only in certain artistic industries, but also several other foreign undertakings, such as those which produce and sell the famous brands of sherry, in the case of which the proportion attributed to the head office of the management has exceeded 40 per cent of the profits.

2. Apportionment of Debts of Real Centre of Management to Branch.

The bonded indebtedness of a company is divided between the centre of management and the branches in proportion to the profits or capital—*i.e.*, by means of the application of the comparative ratio for business carried on in Spain as drawn up by the jury.

This principle of proportional distribution is inherent in the Spanish system in the sense that it derives directly from the criterion of taxation (*Steuermassstab*), which in the Spanish system is, as has been shown above, net profit. The application of this principle is so strict that even during the war when, for the purpose of participating in war loans, large-scale undertakings in the belligerent countries had recourse to the issue of bonds on the Spanish market, which bonds were almost entirely subscribed by Spaniards, the interest on the loans in question was taxed in Spain only in proportion to the business handled by such undertakings within the kingdom—that is to say, by means of the application of the comparative ratio drawn up by the jury for profits.

As has been said on more than one occasion, Spanish law always considers the undertaking as a whole and consequently the total bonded debt of the undertaking is considered in relation to the total assets of the undertaking itself.

The only distinction which plays any important part in Spanish administrative practice is that made between secured indebtedness, on the one hand, and debts relating to the exploitation and administration, on the other. These latter are represented on the debit accounts of the supplying enterprises. Such debts are charged to each establishment in accordance with commercial practice. The same rule is followed in the case of credits extended or obtained by the branches of foreign banks, when the jury is not bound by the provisions of the Anglo-Spanish treaty referred to above.

3. Apportionment of Net Profits of Branch to Parent in Deficit and vice versa.

Apportionment of Net Profits of Branch to Parent in Deficit.

Business turnover in Spain is always expressed by a comparative ratio and in practice by a percentage. The necessary corollary of this provision of the law is that, if the undertaking as a whole has made no profits, no tax is due in Spain on profits made in the country. The comparative ratio applies in such a case only for the purpose of determining the minimum payment on the basis of capital whatever the importance of the profits shown by the accounts of the Spanish undertakings.

Apportionment of Net Profits of Parent to Branch in Deficit.

In very many cases, a Spanish undertaking which has made losses is taxed if the undertaking as a whole has made profits. Nevertheless, if the undertaking has a subsidiary company in Spain the administration of which enjoys absolute economic independence and which, in practice, has made no profit or has incurred losses, this latter undertaking will not be subject to a tax on profits. It will, in all respects, receive treatment equal to that of a Spanish undertaking in the same circumstances.

II. APPLICATION OF THE METHODS OF ALLOCATION IN SPECIFIC CASES.

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

I. *Selling Establishments.**Local Establishments selling in National Markets.*

If the foreign undertaking has its factories abroad or if it buys goods abroad which it sells in Spain through the medium of a permanent establishment in the sense of Spanish law, one of the typical cases of the Spanish system arises. As has been said, the Spanish system excludes in principle the attempt to estimate production costs. Now, in the case under consideration, such an attempt is an indispensable condition for the verification of the separate accounting involved. Nevertheless, in the case of articles the price of which can be very easily verified without violating the administrative secrets of the undertaking, the Spanish experts, with rare exceptions, take the separate accounting as the basis for calculating the ratio for the business of the company in Spain. In almost all cases, recourse is had to the distribution of profit between manufacture and sales. In the case of business for which practical commerce has created definite rates of commission (e.g., fine wines, books, etc.) the experts of the jury, taking account of the expenses and economic responsibilities which fall upon the producer in addition to commissions, increase by so much the total of the commissions. The difference between this sum and the selling charges incurred by the undertaking is thus considered as average commercial profit (three years) divided if necessary between Spain and other countries. When these conditions are not present, recourse is had to the experience of independent manufacturing and mercantile enterprises for the purpose of establishing a relation between the respective profits for a given volume of production. If it is not possible to apply this method, the experts endeavour to find out whether there is any appreciable difference between manufacturing risks and selling risks. If there is not, the profits are divided in proportion to the capital used. The most important problem is that of the distribution of stocks between the factories and the selling establishments. The solution of this problem differs according as the undertakings under consideration do or do not sell on the instalment system. In the first case, the accounts for "clients" and "goods in warehouse" are balanced mainly by the credit account of the head office with the branch; but, in the case of ordinary sales, the distribution of stocks is subjected to special expert treatment by the jury and the experts of the undertaking.

The jury takes account of the difference in risks for foreign undertakings only in cases in which this difference is very clear and generally admitted to exist. It is a general principle of the Spanish jury never to enter to the account of a foreign undertaking any items which might be of a doubtful nature.

In several cases, another problem arises. If the undertaking manufacturing abroad wishes to obtain the greatest possible profit from its selling organisation, it completes its choice of goods with other articles which it buys generally in Spain. In such cases, the reselling business is separated from the main business and selling charges are calculated in proportion to the volume of the respective businesses. If the undertaking does not produce its own articles abroad but merely buys goods abroad which its permanent establishment sells in Spain, the method of evaluation is very different from the above. In this case, an attempt is made to find out whether or not the undertaking possesses a selling organisation abroad. In the first case, an estimate is made of the amount of capital involved and of the commercial organisation. According to the comparative importance of one or the other factor, account is taken of the capital used or the wages of the staff of the undertaking. In very many cases the two factors are taken account of.

Local Establishments of Foreign Enterprises selling Abroad.

Operations effected outside of Spain are always imputed to the central management, even if it is in Spain that the operations in question are dealt with and accounted for—*i.e.*, “controlled”, in the strictest sense of the term. The case is very frequent in Spain, in view of the fact that the Spanish branches of foreign undertakings also deal with business connected with Portugal and Morocco.

2. Manufacturing Establishments.

The act of manufacture always gives rise in Spain to an obligation to pay taxes. This results from the definition described above of what the law understands by “business in Spain”. It will be remembered that in no case can profits be ascribed to a Spanish business if the business as a whole makes no profits. If the profits made by the undertaking out of manufacture are absorbed by losses arising from sales abroad, there will be no taxable profit in Spain and the figure arrived at by the jury will serve as a basis merely for the minimum payment on the basis of capital.

3. Buying Establishments.

Purchases effected in Spain through the medium of a suitable establishment none the less incur an obligation to pay taxes. The number of foreign undertakings covered in this point of the questionnaire is considerable in Spain. In principle, the actual transaction of purchase and sale is considered as a whole and an attempt is made to discover the comparative importance in commercial practice of each of these partial operations. Generally speaking, according to information acquired by our experts in the case of the majority of goods, purchase is less important than sale. In actual fact, commercial practice has led to the fixing of well-defined rates of commission which are applied in ordinary cases by the experts of the jury.

There are, nevertheless, exceptions—*e.g.*, in the case of undertakings which purchase perfumes of Spanish mountain wild flowers the operation of purchase is considerably more important than that of sale. The latter is a simple and current commercial operation. Purchase, on the other hand, necessitates considerable organisation, implying a most active and expensive system of control.

On the other hand if the undertaking, while making purchases in Spain, has no permanent establishment there in the sense of Spanish law referred to above, it is not subject to Spanish taxation. Generally speaking, foreign undertakings employ Spanish agents or foreigners domiciled in Spain who are individually subject to the *patente* tax.

(b) BANKS AND BANKING COMPANIES.

Reference has already been made more than once to the restrictions which the treaty in question imposes on the proper taxation of the profits of branches of deposit banks. The restrictions arise from the fact that, under the treaty, the maximum comparative ratio is fixed by the relation between the deposit and current accounts of the branch and those of the undertaking as a whole.

A similar restriction is imposed by the Italo-Spanish Treaty. The treaty with France is much more elastic in this respect, and it would accordingly be possible to make much more accurate allocations on this basis if agreement could be reached on what was to be understood by most-favoured-nation treatment, which is assured in all three treaties.

In cases which are not covered by any treaty, the jury considers in the first place the degree of economic independence possessed by the branch. If it carries out its active operations by means of the financial resources derived from its passive operations in Spain, the real profits

are taken as a basis for the comparative ratio fixed by the jury, provided that the profits made by the undertaking as a whole are still greater. If the book-keeping of the undertaking is not such as to satisfy the Spanish Administration, some empirical method is applied ; but such cases are very rare in practice.

It should be noted that sometimes, notwithstanding the restrictions imposed by the Anglo-Spanish Treaty, the members of the jury, who are, of course, thoroughly conversant with the banking situation, have fixed much lower ratios than those authorised by the Treaty because some Spanish branch of the foreign bank in question was not doing well. The restrictions which the treaty in question imposes on action of this kind have been explained above.

It may be interesting to mention a case in which an empirical method was applied in the absence of a satisfactory system of book-keeping. This case arose only once in Spain, at the time when the jury was set up. The method in question is, we believe, more frequently used in foreign countries. It was proposed to make an estimate of the probable profits of the branch in question during the period under consideration by comparison with Spanish establishments of a similar kind. Such strong opposition to this method was manifested on the jury that it was never employed again. This case is extremely instructive as illustrating the spirit in which the jury makes its estimates. The estimate favoured by the majority of the jury was lower than that resulting from comparison with Spanish establishments of a similar kind.

If the branch does not possess real economic independence, the jury makes a special study of the principles according to which the Spanish establishment is managed, and the method applied depends entirely on the conclusions reached by that study.

If the bank is one which collects capital in the country in order to utilise it in other countries, then the estimate is based upon its passive operations ; the contrary is the case if the branch is mainly engaged in utilising in Spain capital which it receives from other countries. These are of course extreme cases. Generally the final estimate lies between the two extremes, though it approaches one of them more nearly than the other. Until the time when the trade in foreign bills was centralised, the jury took particular account of the specific requirements of those banks of which foreign trade made use for investing available capital in the financial markets of world commerce.

(c) INSURANCE COMPANIES.

Reference has been made above to the rule laid down by law concerning estimates with regard to insurance companies, and it has been explained that this represents a concession made by the Spanish Government to the demands of undertakings established in the country. The rule as laid down by law has some degree of elasticity, but it has been embodied in a rigid form in the international treaties which Spain has concluded.

According to the treaties, the relative maximum figure should be given by the relation between the amounts of the premiums paid in ; but the treaties contain no definition of the legal meaning of the term " premium ".

In cases where the treaties do not apply, the jury makes much more detailed estimates than those which result from the rules laid down by the treaties. The principal differences are as follows :

(1) In fixing the proportion of premiums, a different degree of importance is attributed to each of the various branches of insurance in accordance with the relation shown by the book-keeping to exist between the premiums and profits of the various branches of insurance dealt with by the establishment in Spain.

(2) Allowance is made for special conditions as regards competition, or conversely the existence of cartels or other kinds of agreement between different undertakings.

(d) RAILROAD, MOTOR-BUS AND OTHER TRANSPORT COMPANIES.

The "Compagnie Internationale des Wagons-Lits" is the only case in point. The method employed has always been based on the relative amount of receipts obtained on Spanish lines. Adjustments have sometimes been made to take account of the difference in the rates charged in Spain, due to certain difficulties encountered by the Company in raising its charges in Spain.

(e) POWER AND LIGHT COMPANIES.

The foreign companies for the supply of electrical power which carry on business in Spain do not carry on business in any other country, with the exception of those which supply both electric light and gas.

(f) GAS COMPANIES.

The most usual method is based on the assets, account being also taken of credits granted and obtained by the undertaking. The preliminary estimate thus made is then modified on the basis, first, of the rates charged, and secondly of the price of coal in Spain. In certain cases, a further adjustment is made to take account of appreciable differences in the relative frequency of services. The resulting estimate is compared with that derived from the book-keeping. If the difference between the two does not exceed a reasonable amount, the profits as shown by the books are taken as the basis. It very often happens, however, that there is a great divergence between the two figures, mainly owing to the prices charged for the coal and other materials supplied to the Spanish enterprises. In that case, the result of the estimate made in the manner described above is, of course, taken as a basis for the comparative ratio fixed by the jury.

(g) TELEGRAPH AND TELEPHONE COMPANIES.

As the telephone service is a monopoly in Spain, the only company in existence is the Compañía Telefonica Nacional—an ostensibly Spanish concern, the creation of which drew down the most violent criticism on the Dictatorship. Up to the present, under the influence of the Government, the Company has been treated as an independent concern and taxed as a Spanish company. It is difficult to foretell whether this method of taxation will continue to be applied by the Administration of Finances when the parliamentary system has been restored in Spain.

(h) MINING AND EXTRACTIVE INDUSTRIES.

Foreign mining companies which operate in Spain fall into groups which differ very widely one from another from the point of view of allocation methods. The principal groups are as follows:

1. *Mining Companies in the Strict Sense of the Word.*—Generally, such companies do not carry on operations outside Spain, except so far as the offices of the management are concerned. The problem of allocation thus merely consists in determining what importance is to be attributed to the management in the undertaking. In nearly all cases, the ores extracted are disposed of on markets which have been organised for many years, so that the management has hardly any important problems to settle. The jury usually allots about 10 per cent of the profits to the management office, and the remaining 90 per cent to Spain. It may be pointed

out incidentally that the figure of 10 per cent is not, as might be supposed, a more or less traditional figure derived from other laws, such as the Austrian laws of 1896 to 1900. There are some concerns which market the ores produced by a number of Spanish producers, and it is on the basis of the experience acquired in connection with these undertakings that this figure, which has been worked out several times by the Administration, has been adopted in Spanish practice.

2. *Enterprises which exploit Mines and process the Ores in Spain and Abroad.* — If the manufacturing is kept distinct from an economic viewpoint, and is carried on by a sufficient number of concerns, such as the "Purchasers", in connection with the production of copper, the jury endeavours to ascertain the relative importance of each of the two kinds of work taken separately.

If, in the opinion of the experts, the experience acquired in this connection is not sufficient to constitute an adequate basis for such a distinction, the amount of capital invested in each kind of business is taken as a basis. Very often the result reached by this method is regarded only as a preliminary estimate, which is subsequently modified if necessary in view of special circumstances, such as a difference in the risk to which capital is exposed. It should be noted that the income derived from holding securities is always allocated to the management office in a foreign country. In the case of some of the companies in question such holding was considerable during the war, on account of the public loans to which they subscribed, and which has since increased still further owing to purchases of the shares of other mining companies. Another general rule followed in Spanish practice is as follows: accumulated stocks of ore, which are usually kept in Spain, are left out of account in calculating the proportion. The reason for this is that the undertaking could quite well keep its stocks of ore outside Spain, even though such a practice would not be very satisfactory economically, if the difference in the amount payable in taxation made it advantageous for it to do so. Spanish practice is based on the principle that, except where required by law, the incidence of taxation should not constitute an obstacle to the management of the undertaking in the most economically satisfactory way.

Another point which appears worthy of remark is that the part of the assets represented by the mineral deposits is not evaluated according to the statements in the company's accounts, but is specially estimated by State mining experts. The principal reason for this is that it has been noted that the price paid by foreign companies for their mineral deposits often differs very considerably from the actual value of the mines, often exceeding rather than falling below that value.

When the problem of the allocation of the profits of companies of this kind was submitted to the experts of the Ministry of Finance, they made a careful study of a method which is often suggested by the companies' experts—namely, the method of taking as a basis the difference between the value of the ore and the cost of extraction. The Spanish experts finally rejected that method because of the very great differences produced in the result by comparatively slight variations in the quality or purity of the ore. It is not practically possible for the Administration to check the quality of the ore, on account of the diversity of quality which may occur in the same deposit. The view taken by the Spanish experts has recently been strikingly confirmed in the case of a mining company of the kind now in question. Owing to the indiscretion of one of the foreign heads of the company, the Spanish Administration came into possession of the key to its telegraphic code, and this led to the discovery of a flagrant fraud based on slight differences in the declared quality of the ore. The additional sums which the company had to pay in the form of mining dues amounted to several million pesetas, but the tax on profits was not modified because the jury had allocated profits according to the system which has been described above, and had rejected the system based on the value of the minerals, the adoption of which had been persistently urged by the fraudulent company.

3. *Undertakings in which Mining only plays a Secondary or Supplementary Part in the undertaking as a Whole.* — In these cases, the jury allocates profits by means of the methods usually employed in business. It should, however, be noted that, if the profits of the mining work in Spain are absorbed by losses suffered in other business abroad, the undertaking is not taxed on the profits acquired in Spain.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

I. GENERAL METHODS OF ALLOCATION.

As stated above, Spanish undertakings were taxable on their total profits until the reform of 1924. Since then, Spanish companies operating abroad have enjoyed the same treatment as foreign companies operating in several countries, except as stated below.

The methods employed to determine the proportion of the Spanish company's profits earned abroad are exactly the same as those just described.

Dividends and interest received by a Spanish company operating abroad are exempt in Spain if such income is deemed by the jury to belong to its foreign business.

II. ALLOCATION OF PROFIT TO REAL CENTRE OF MANAGEMENT WITHIN THE COUNTRY.

In Spanish law, the only difference between a Spanish company and a foreign company both of which operate in Spain and abroad is that the Spanish company has to pay tax in Spain on at least a third of its profits. In view of the form in which the question is worded, it should be pointed out that this limitation does not apply to the foreign company even if its centre of management is in Spain. The reason for this difference is quite clearly explained in the preamble to the Legislative Decree of 1924: the reason for the charge is in *nationality*. The obligation would therefore subsist even if the Spanish company had its real centre of management abroad. On the other hand, a company regarded as foreign according to the common law of Spain would not be liable for tax on a minimum of a third even if it had its real centre of management in Spain.

In this latter case, the fraction of the profits ascribed to the head office would be determined by the same rules as in the case of a foreign company having its centre of management abroad.

C. HOLDING COMPANIES.

Spanish fiscal law as it affects holding companies and investment trusts was arrested in its infancy by the instability of the exchange rates. The restrictions imposed by this situation on our economic and fiscal policy, in order to relieve the balance of payments of the greater part of the capital exports, brought the process of development that began in 1920 to a standstill. In point of fact, the idea of regulating questions relating specifically to companies formed for the purpose of acquiring and holding securities, whether in order to obtain control or as investments, dates back much farther.

In the 1920 reform scheme, this question was held over. The preliminary draft prepared by the Administration contained a clause which, though very cautiously worded, represented a first step in the direction of different treatment. The Minister of Finance, however, left the question unsettled, on account of the loss of revenue that was anticipated if the reform should be carried through. But when the Bills came up for discussion, a return was made to the preliminary draft, and a clause was incorporated to the effect that 80 per cent of the total dividends drawn by a company liable for the tax on profits should be deducted from the profits if the companies that paid the dividends were themselves liable to a tax on profits. It was thought that the fiscal law could thus, step by step, be completely accommodated to the special position

of these companies ; but, as we have said, the foreign exchange situation made this impossible. Consequently, in 1924, not merely was the definition of foreign transactions not expanded for the benefit of purely Spanish holding companies, but Spanish holding companies and investment trusts were expressly excluded from the advantages conceded to national companies doing business abroad.

This unfinished state of Spanish law is the cause of certain difficulties in interpreting the legal provision mentioned above. If the dividends drawn by a Spanish company are paid by a foreign company, is 80 per cent of that income to be deducted from the profits ? The Spanish Administration, relying on the letter of the law, has replied in the negative. That being so, Spanish companies which control foreign companies would be in a considerably inferior position, had not the experts on the jury drawn from the principle of economic unity "fortunate consequences" for the development of Spanish holding companies.

I. NATIONAL HOLDING COMPANY CONTROLLING FOREIGN SUBSIDIARIES.

According to this interpretation, if a Spanish company controls a foreign company or companies which do all their business abroad, it is regarded as doing that business itself ; in other words, the direct conduct of a transaction and its conduct through a subsidiary company are placed on the same footing by the jury in the case of Spanish companies.

Obviously many other questions are as yet unsettled, and will remain so until the development of the law regarding holding companies is resumed.

The most important of these outstanding questions relates to the fact that a holding company in the proper sense of the term, or an investment trust, if Spanish, is still liable in Spain for tax on all its profits, all its dividends, and all the interest on its bonds.

Recently, the question of holding companies and investment trusts has received serious attention from the Government and the administrative services ; but this movement has again been stopped by the state of the exchange.

II. LOCAL SUBSIDIARY COMPANY CONTROLLED BY A FOREIGN HOLDING COMPANY.

There are a great many such companies in Spain. If the local company is administered in its own interest with complete economic independence, it is treated in every respect as a Spanish company. If, however, the Administration finds that the company is managed simply as a branch, and in complete union with the parent company, it makes a declaration to that effect in the following cases :

(a) When the managers of the company are not of Spanish nationality, or when, though they are of Spanish nationality, there are not enough of them domiciled in Spain for them to make decisions.

(b) When the persons legally responsible for the management of the company are under the control of the foreign company, whether because they are officials or in consequence of contracts or agreements.

(c) When the registered name of the company or the additional indications used by it in published documents and business papers make it clear that the company is operating in Spain under the control of a foreign company.

(d) When the Administration has valid evidence that a foreign company holds such a large proportion of the securities representing the company's capital that it can enforce its decisions at general meetings of shareholders and in the business management of the company.

If the company accepts the declaration, or—should it refuse to do so—if the court having jurisdiction confirms the Administration's decision, the Spanish company is liable for tax as if it were a branch of the parent company.

There has not, as a matter of fact, been a single case in which the Administration's declaration has not been accepted by the subsidiary company—which is surprising in Spain, where foreign companies make claims which are not always justified, owing to mistaken zeal on the part of their lawyers. This acquiescence is explained by the prudence displayed by the Spanish Administration in its declarations, which it makes only in very flagrant cases.

In consequence of this cautious attitude on the part of the Spanish Administration, some very difficult questions are beginning to arise, which, so far as we are aware, are still awaiting a solution. We refer to the deduction of payments made by the local company to the holding company, which thereby reduces the profits of the Spanish company.

These payments fall into various classes, but all have this in common: that they skim the cream off the profits of the controlled companies. The most important of these classes are: patent and trade-mark royalties; payments to the persons in charge of the auditing, the technical services, and the commercial services. These last fall into two distinct groups—buying and selling contracts, and financial assistance. In some cases, the contracts are of such a nature as to skim off not merely the cream, but also the whey. This is sometimes remedied by a clause to the effect that if, after all these services have been paid for, there is nothing left for the subsidiary company, the amount of the payments must be so reduced as to leave the fortunate shareholders of the subsidiary who are not also shareholders of the holding company at least the shadow of a dividend. According to our experience in Spain, the masterpiece among all this marvellous collection of devices is the exercise of control through buying contracts.

We cannot at present anticipate what the Spanish Administration will decide as to these deductions.

D. DIFFICULTIES AND RECOMMENDATIONS.

I. DIFFICULTIES IN TAXING FOREIGN AND NATIONAL ENTERPRISES.

When the system of separate accounting was permanently superseded by the method of fractional apportionment, foreign companies tried to work up an agitation against the law of 1920. The more wary directors realised, however, that it would have been extremely unwise to go against so broad, powerful and well-justified a current of opinion. They must by now be convinced that, in Spain, as elsewhere, the taxes are far too high for the natives to feel inclined to make presents to their foreign competitors. Indeed, so few complaints are made by foreign concerns, that it is regarded as an exceptional thing if there are as many as two or three in a whole year. When complaints are made, they are nearly always due to the misplaced zeal of the Spanish representatives of foreign companies.

II. RECOMMENDATIONS TO THE FISCAL COMMITTEE.

In the foregoing remarks, we have tried to illustrate the principles of the Spanish system of taxation for international undertakings. We have called attention to the lack of consistency in the system, due to the results of extraordinary legislation enacted during grave crises in the finances of Spain. And we have mentioned the progressive plans that have been arrested by one circumstance or another.

Obviously, as our system develops, the obsolete parts will be eliminated and the incomplete parts completed.

Regarded from this standpoint, it seems clear that there is no longer any reason for a large number of taxes on one and the same thing—namely, net income. We do not know the strength of the causes that led to this system of multiple taxes in the history of Spanish finance, but we feel that those causes have now disappeared, or at any rate lost much of their force.

As for the regime of holding companies and investment trusts, there seems little doubt that this will soon be satisfactorily completed when the exchange is stabilised.

We would now emphasise the essential feature of the Spanish system, regarded as a whole.

We find this essential feature in the fact that the allocation of profits is not part of the ordinary procedure of tax assessment, but is in itself a legal act independent of, and separate from, the procedure followed by the competent authorities.

This independent legal status of allocation as such is based on the theory that allocation is on an entirely different plane from taxation.

As we have explained, allocation is the concern of the jury alone. At first sight, it might be thought that the Financial Administration was more largely represented on the jury than private interests; but such is not the case. The expert appointed on personal grounds in no way represents the Treasury, and the jury itself is always composed of prominent financiers.

The aim of legislation has been, in the settlement of procedure as in the provision for the appointment of the jury, to keep the matter of allocation remote from any fiscal influence. The jury must of course necessarily hear the views of the persons concerned. In every case, moreover, the jury is obliged to ask for the opinion of manufacturers, traders, miners, etc. There is a very distinct provision in the law to the effect that if, in any country, the opinion of the Spanish chambers of commerce abroad with regard to the allocation of the profits of Spanish companies must be obtained, this entails a reciprocal obligation for the jury. In practice, the jury carries its investigations much further than it is strictly bound to do. In this connection it is an interesting point that, when requested by the persons involved, the jury seeks to obtain information from any other secret source, and that not the least trace of such information can be found in the official files.

Only when the allocation has acquired the force of law does the ordinary procedure of tax assessment begin.

In our view, if ever an international body were set up to deal with the fiscal position of undertakings operating in several countries, the allocation would provide a firm foundation, while there would be no need to interfere with the machinery of tax assessment in the different countries.

This feature of the Spanish system which we have just described is what makes the Spanish methods of allocation so admirable: everything is done on a proper business footing, and not in an atmosphere of fiscal administration, as is commonly the case elsewhere. As we have said, the Spanish jury always approaches a question of allocating profits as if it were a business transaction, and employs the same methods as are used by business men in similar cases.

A general solution of the problem of the allocation of profits is not really possible unless it passes the "100 per cent test". It has been seen that the Spanish system not merely passes that test, but is actually constructed upon that basis. The system of economic unity would appear to spring from this fundamental consideration.

Whereas the system of economic unity is pushed to its logical extreme as applied to Spanish companies, it is hedged in with a series of very effectual guarantees when it is applied to the affairs of a concern which is legally a foreign one. In this respect, we feel that the Spanish system answers to the necessary requirements—namely, that the powers of the Administration should be defined by law, that the cases in which a declaration of economic unity may be made should be specifically enumerated in the law, and that the tax should not be assessable until the decision reached in this matter has become final.

As we have observed, however, these restrictions on the application of the principle of economic unity give rise to very thorny problems in connection with the valuation of the

royalties, fees, services and contributions of all kinds paid by the subsidiary to the parent company. For these problems, which have only latterly arisen in Spain, we have as yet no definite rule.

Lastly, among the noteworthy advantages of our system, mention should be made of the absence of vague and unspecific terms such as "production costs", which have no legal definition and yet carry serious practical consequences in other countries.

Taken as a whole, the Spanish system of apportioning profits deserves the honour in which it is held by business men in Spain. They cannot understand how anybody can be in doubt, at the present time, which is the better—a system so solidly constructed as the Spanish system, or a system so primitive as that of separate accounts, with which it must be admitted *a priori* that, although the operation of one undertaking may be completely controlled by another, yet the former is independent of the latter, or that the ideal of taxation is to make a concern running at a loss pay the tax on profits. The pious Spaniard has no longer a faith so profound.

ANNEX.

TARIFF OF TAXES ON SALARIES AND WAGES, AND ON DIVIDENDS, INTEREST AND PROFITS.

First Schedule			Second Schedule						Third Schedule			
Salaries and wages			Dividends			Interest			Tariff No.	If the profits		Taxation rate
Exceeding	Not exceeding	Rate	If the dividend		Taxation rate	If the interest		Taxation rate		exceed	do not exceed	
Pesetas		%	exceeds	does not exceed		exceeds	does not exceed			the rates given below in proportion to the nominal value	the rates given below in proportion to paid-up capital, plus reserves	
			the rates given below in proportion to the paid-up capital plus total reserves		the rates given below in proportion to the nominal value		%					
1,500	2,000	2.5	—	5	5.50	—	4	6	1	—	5	6
2,000	3,000	3.0	5	6	6.60	—	4	6	2	5	5.5	7
3,000	4,000	3.5	6	7	6.90	4	6	6.50	3	5.5	6	7.8
4,000	5,000	4.0	7	10	8.05	—	—	—	4	6	6.5	8.6
5,000	6,000	4.5	10	14	9.20	6	6.99	7	5	6.5	7	9.3
6,000	7,000	5.0	14	20	10.35	—	—	—	6	7	7.5	10
7,000	8,000	5.5	20	25	11.50	7	—	7.50	7	7.5	8	10.6
8,000	9,000	6.0	25	—	17.25	—	—	—	8	8	9	11.1
9,000	11,000	7.0	—	—	—	—	—	—	9	9	10	12
11,000	13,000	8.0	—	—	—	—	—	—	10	10	11	12.6
13,000	15,000	9.0	—	—	—	—	—	—	11	11	12	13
15,000	20,000	10.0	—	—	—	—	—	—	12	12	13	13.5
20,000	—	11.0	—	—	—	—	—	—	13	13	14	13.8
									14	14	15	14
									15	The proportion of profits exceeding 15 per cent is taxed at the rate of		15

**TAX SYSTEM AND ALLOCATION METHODS
IN THE UNITED KINGDOM**

by

E. W. VERITY

Principal, Board of Inland Revenue.

PART I. — GENERAL DESCRIPTION OF INCOME-TAX SYSTEM.

I. SCHEME OF THE TAX.

Income tax has the largest yield of any single tax in the British system of taxation. In the main, it is a tax on the incomes of individuals, for nearly 90 per cent of the total actual income of £2,520,000,000 assessed to tax in 1929-30 was distributed among individuals resident in the United Kingdom, while the remaining 10 per cent accrued to, and was retained by, corporate bodies—*e.g.*, undistributed profits of limited liability companies—or accrued to persons resident outside the United Kingdom. The income tax paid by individuals resident in the United Kingdom is a graduated tax, that is, the real effective rate of tax levied on each pound of actual total income rises gradually from a fraction of a penny in the pound until, including the surtax, it closely approaches a maximum rate of 13s. 4d. in the pound. Income tax paid by individuals is thus one tax on the total income of the individual, and not a series of taxes on the separate sources of his income. It is imposed in terms of a "standard rate" for a "year of assessment"¹ (5s. in the pound for the year 1931-32) and there are also higher rates applicable to individuals whose total incomes exceed £2,000 per annum, the difference between the tax at the standard rate and the tax at the appropriate higher rates being the surtax applicable to the individual concerned. (A statement of the surtax rates—*i.e.*, the rates in excess of the standard rate—for the year 1930-31 is set out on page 180.)

The object of the operations of assessment and collection of the income tax is to secure that every individual pays just that amount of tax which is proper to his particular total income and circumstances, and that all non-personal income bears tax at the standard rate of tax in force for the year of assessment. These operations may be divided into three categories; first, the ascertainment of the amount of income liable to be taxed; secondly, the application to the taxable income of the machinery by which the tax is graduated; thirdly, the collection of the tax, including repayment of tax found not to be due.

2. GENERAL SCOPE OF THE TAX.

Income tax extends, broadly speaking, to:

- (a) All income arising in the United Kingdom, by whomsoever it may be enjoyed, and,
- (b) All income accruing to a person residing in the United Kingdom, without regard to the place where it may arise.

The tax thus rests on two bases; it applies to all income which has its origin in the United Kingdom, and to all income which accrues to a resident within the United Kingdom. Four main exceptions to these broad principles may be noted:

- (i) The interest on certain British Government securities issued during the war is not liable to income tax so long as the securities are proved to be in the beneficial ownership of persons not ordinarily resident in the United Kingdom.

¹ The "year of assessment" runs from April 6th in one calendar year to April 5th in the following year.

(ii) Persons resident in the Irish Free State are not liable to United Kingdom income tax, there being a reciprocal agreement between the United Kingdom and the Irish Free State under which each country exempts income arising within its borders to persons resident in the other.

(iii) In certain cases dominion and foreign shipping companies are, under reciprocal agreements, exempt from United Kingdom income tax in respect of shipping profits arising in the United Kingdom.

Provision exists for the making of similar reciprocal exemption agreements in the case of dominion and foreign air transport companies, but no such agreements have yet been concluded.

(iv) Income arising abroad from dominion or foreign possessions, other than securities, stocks, shares and rents, is chargeable, not on the full amount of the income arising, but on the amount of the income actually remitted to the person residing in the United Kingdom.

The expression "person residing in the United Kingdom" includes, as well as individuals, companies or other bodies or associations of individuals. Broadly speaking, an individual is considered to be resident in the United Kingdom if:

(a) He is a British subject, usually residing in the United Kingdom, including any such who may happen to be abroad temporarily;

(b) Whether or not a British subject, he maintains a residence in the United Kingdom—unless he is abroad for the whole of the year of assessment, or,

(c) Whether or not a British subject, he resides in the United Kingdom for a period or periods amounting to six months in the year of assessment;

(d) Whether or not a British subject, if he visits the United Kingdom year after year (so that his visits become in effect part of his habit of life) and the annual visits are for a substantial period or periods of time (though less than six months).

In the case of companies, the question of residence has been the subject of numerous decisions in the courts, from which has emerged the broad position that, if the central management and control¹ of the operations of a company is actually exercised in the United Kingdom, the company, wherever it may be incorporated, or wherever its trading operations may be conducted, is resident in the United Kingdom.

¹ The central management and control of a company would normally be exercised by the Board of Directors, and the place where the directors hold their meetings and conduct their business is an important factor in determining where the control of the company is exercised. In a particular case, of course, the Articles of Association of the company might place the effective control of the company in the hands of some other body (*e.g.*, a local board where the main operations are carried on), but this is exceptional. In the case of *B. W. Noble Ltd. v. Mitchell* (11 T.C., 411) the judge indicated the sort of test applied by the courts: "Of course we know the San Paulo case (*San Paulo (Brazilian) Railway Co. Ltd. v. Carter* (3 T.C., 344 and 407)) which it all starts from really, where the seat of the head and brains of the business—a classical phrase—was mainly the determining factor. Mr. Konstam has said quite rightly that the head and brains do not reside where there is some ultimate power of control, such as the power to alter articles by special resolution or power to interfere with fundamental finance such as there was in the *Egyptian Hotels* case. I think that is true. But, on the other hand, I do not think, when the head and brains are mentioned, it is intended to allude to a clever manager. One might say in many businesses: 'The whole head and brains of this business are in the general manager; he knows all about it and far more than all the directors put together'. Therefore they leave it to him, and they are well advised in doing so. It is not in that sense that the reference to the head and brains is made. I do not think the cleverest servant in the world, although he possessed all the brains of the institution, could be said to be the head and brains for the purposes of the San Paulo case".

In general, the income of a married woman living with her husband is treated as the income of the husband. The aggregate income of husband and wife, in so far as tax is not collected at the source (see below), is assessed upon the husband, and the tax is payable by him. Either the husband or wife may, however, upon due application, be assessed on their respective incomes as if they were not married, and in such cases separate assessments are made upon each, and the tax payable is recovered from the husband and wife respectively (with an ultimate right of resort to the husband for the wife's tax). Notwithstanding this, the income of husband and wife is treated as one for purposes of the graduation of the tax, and the effect of separate assessment is, not to reduce the total amount of tax payable by both spouses, but only to divide it between them, broadly speaking, in proportion to their respective incomes.

The law provides for the exemption from tax in certain circumstances of certain kinds of income, or of the income of specified bodies. Some of these exemptions are mentioned below in describing the chief rules under the various schedules of the tax; there are also miscellaneous exemptions in favour of income from wounds and disability pensions, war gratuities, scholarship incomes, the income of charities and friendly societies, and the income under Schedules C and D of industrial and provident societies, etc.

3. ASCERTAINMENT OF THE TAXABLE INCOME.

The tax, as set out in the Income Tax Act, 1918, is based upon a division of income into five classes or "Schedules", called A, B, C, D and E. The law does not attempt a general covering definition of income, but defines the income that falls under each of these five divisions.

The five schedules and their general scope are:

Schedule	General Scope
A	Income from the ownership of lands, houses, etc.
B	Income from the occupation of lands.
C	Income paid under deduction of tax at the source out of any public revenue.
D	Income from trades, professions and vocations; foreign securities and possessions: interest and miscellaneous items of income.
E	Income from employments.

The actual income in respect of which tax is charged *for* any year of assessment may, but commonly does not, represent the actual income received by the taxpayer *in* the year. This arises from the fact that the Income Tax Acts provide a variety of rules for the assessment of different classes of income under the five schedules, the assessment being based in some cases on the actual income of the year of assessment, in other cases on the preceding year's income, etc.

The following paragraphs contain a brief description of the principal rules under the various schedules of the tax. In addition there are numerous and detailed provisions for special circumstances and cases, as for example, new businesses, businesses discontinued, changes in proprietorship, losses made in business or in the occupation of lands, the assessment of partnerships controlled abroad, banks, life insurance companies and so on.

SCHEDULE A. — INCOME FROM THE OWNERSHIP OF LANDS, HOUSES, ETC.

This schedule includes the annual values of all lands, houses, buildings, etc., in the United Kingdom. The expression "lands" includes farmhouses occupied by tenant farmers or farm servants and also farm buildings. Broadly speaking, annual value of land and buildings

means the rent at which the property is let or is worth to be let by the year, the tenant bearing the usual tenant's rates and taxes, and the landlord bearing the cost of repairs, etc. Annual value for the purpose of Schedule A throughout Great Britain is determined quinquennially, and the value thus fixed is continued, subject to the qualifications stated below, during the intervening years. A new assessment, begun in 1930-31, will come into force for the year of assessment 1931-32. The annual value fixed at the periodic date is subject to increase in the case of structural alterations to a property, and new properties are brought into assessment at their appropriate annual values. Reductions of annual value are made, on proof that the annual value has diminished.

The annual value determined in the manner described constitutes the gross assessment. From the annual value or gross income there is deducted, in order to arrive at the actual income, certain statutory allowances or deductions. Subject to certain restrictions, there is deducted from the gross assessment, at the time the assessment is made, a normal flat-rate allowance in respect of the cost of repairs (the precise fraction of the amount of the assessment allowed as a deduction depends upon the annual value of the property). A further deduction is allowed in respect of the excess of the average annual expenditure for the five preceding years on maintenance, repairs, insurance and management over the flat-rate repairs allowance. This allowance for maintenance is made either during the collection of the tax or by repayment of tax after the close of the collection. An appropriate remission of tax is also allowed, normally during the collection of the tax, in respect of any part of the year of assessment during which a house is unoccupied.

The annual value of colleges and halls in universities, hospitals, public schools, almshouses, etc., is duly brought into assessment, but the tax is specially remitted. On the other hand, certain classes of property are not brought into assessment at all—viz., property vested in and in the occupation of the Crown, cathedrals, churches, etc.

SCHEDULE B. — PROFITS FROM THE OCCUPATION OF LANDS (FARMERS' PROFITS MAINLY).

Income tax under Schedule B is charged in respect of profits derived from the occupation of lands. The assessment is made on a conventional basis which assumes that the profits arising bear a relation to the annual value of the lands occupied. For years from 1922-23 onwards, the profits have been assumed to be equal to the annual value of the lands.

The farmer occupying lands for the purpose of husbandry only or mainly for those purposes has, however, a choice between the following methods of assessment:

- (1) He may be assessed on the conventional Schedule B basis, in which case he may obtain, at the end of the year, a reduction of the conventional assessment down to the actual profits of the year, if these are less than the amount of that assessment, or,
- (2) He may elect to be assessed under Schedule D, in which case his profits from the lands occupied will be calculated in the same manner as profits arising from a trade.

In the case of lands not occupied solely or mainly for the purposes of husbandry, the profits have been assumed, for years from 1922-23 onwards, to be equal to one-third of the annual value, instead of equal to the annual value as in the normal case. The profits of nurseries and market gardens are brought into assessment under this schedule, but they are estimated according to the rules of Schedule D.

The profits from the occupation of woodlands are normally brought into assessment under this schedule, but an occupier managing them on a commercial basis with a view to profit may be assessed, in certain conditions, under Schedule D instead, and, in that case, the profits arising from the occupation are calculated in the same manner as profits arising from a trade.

**SCHEDULE C. — INCOME FROM BRITISH, DOMINION, AND FOREIGN GOVERNMENT SECURITIES,
WHERE SUCH INCOME IS TAXED BY DEDUCTION AT THE SOURCE.**

Income tax under Schedule C is charged, in terms of the statute, on all interest, annuities, dividends, etc., payable in the United Kingdom out of any public revenue, whether of the United Kingdom, a British dominion or a foreign State. The tax is collectible at the source. The Bank of England or other agent entrusted with the payment of the interest, etc., is empowered, on making the payments, to deduct therefrom tax at the standard rate in force at the time of payment and is required to pay over tax so deducted to the Revenue. To this general rule, certain exceptions exist, as follows.

No tax is charged in respect of interest, etc., on holdings of Government Departments or of certain official charitable funds, etc.

Interest, etc., payable in the United Kingdom on any securities of a British dominion or a foreign State which are owned by a person not resident in the United Kingdom is not charged to tax, or, if charged, the tax may be reclaimed. This exemption springs from the fact that neither the origin of the income nor the residence of the owner is within the United Kingdom; only the act of payment takes place in this country.

In conformity with the general principle under which all income arising in the United Kingdom is taxable, whether the person entitled thereto resides in the United Kingdom or elsewhere, the interest and dividends on securities of the British Government were, up to the outbreak of war in 1914, taxed under Schedule C by deduction of tax at the source. The war led to a departure from this rule. Most of the British Government securities issued during the war period are distinguished by two features :

- (a) The interest is paid in full without deduction of tax at the source, and it is assessable on the recipient, if necessary, under the rules of Schedule D ;
- (b) The interest paid on securities, which are proved to be in the beneficial ownership of persons who are not ordinarily resident in the United Kingdom, is not liable to tax.

War Savings Certificates and National Savings Certificates, which are issued subject to a limitation on the total number of certificates that may be held by any one individual, carry accumulated interest at the date of their maturity, and are granted exemption from both income tax and surtax in respect of that interest.

Small amounts of interest and dividends payable out of any public revenue, the half-yearly payment in respect of which does not exceed 10s., are not taxed at the source, but are charged on the recipient, if necessary, under the rules of Schedule D.

SCHEDULE D.

Income tax under Schedule D, the principal Schedule of the tax, is charged on the annual profits arising :

- (i) To any person residing in the United Kingdom from property wherever situated (not assessed under Schedule A), or from any trade, profession or vocation, wherever carried on ;
- (ii) To any person not resident in the United Kingdom from property in the United Kingdom (not assessed under Schedule A) or from any trade, profession or vocation exercised within the United Kingdom ;
- (iii) From all interest of money, annuities, or other annual profits not charged under any other schedule and not specially exempted from tax.

The subjects of charge are grouped under six heads called "cases", as follows:

Case	Subject
I.	Profits of trades, manufactures, adventures or concerns in the nature of trade.
II.	Income from professions.
III.	Interest paid in full and assessable directly upon the recipient, including certain interest on British Government securities, as explained above.
IV.	Income from dominion and foreign securities (except that from Government securities assessable under Schedule C);
V.	Income from dominion and foreign possessions;
VI.	Profits from other sources not dealt with under any other schedule.

Profits charged under this schedule are normally computed for the purpose of assessment on the basis of the preceding year's profits of income. (There are special bases prescribed for the first and last years of a business or profession, for changes of proprietorship, for new and ceasing sources of income under Cases III, IV and V and also for Case VI profits.)

A number of rules are prescribed by the Acts for the determination of the amount of profits to be brought into assessment, on the appropriate bases as indicated above. Their chief features are sketched in the following paragraphs.

Case I. — Broadly speaking, trade profit brought into the computation of the assessment is the difference between the gross receipts and the expenses incurred wholly and exclusively for the purposes of the business. Among such expenses may be mentioned debts which are proved to be bad and doubtful debts to the extent that they are estimated to be bad. The net amount upon which tax has been paid under Schedule A in respect of lands and buildings owned by the trader and occupied for the purposes of his business is also deducted in arriving at the profit, in order to avoid a double charge of tax on that part of the total profit of the business. In the case of mills, factories and other similar premises an additional deduction is allowed as explained in the following paragraph. The Acts prohibit deductions in respect of capital charges, lost capital, losses unconnected with the business, and private and domestic expenses. They also prohibit, under the system of collection at the source (see pages 177 and 178), the deduction of certain charges which would normally be regarded as commercial expenses. Such charges include any annual interest on borrowed money, annuity, or other annual payment payable out of the profit, and any royalty in respect of a patent. The total profit brought into the computation of the assessment thus includes these charges, but, as the trader is entitled, on paying the interest, royalty, etc., to deduct therefrom income tax at the standard rate of tax, he recovers in this manner the tax relating to that part of the total profits paid away to other persons.

In ascertaining the trade profits to be brought into computation of the assessment, no deduction is allowed for depreciation of machinery or plant. An allowance is, however, made from any computation under Case I (which, it will be remembered, is upon the preceding year's profits) of such an amount as is considered by the Commissioners in whom jurisdiction for the purpose vests to be just and reasonable as representing the diminished value by reason of wear and tear during the year of assessment of any machinery or plant used for trade and owned by the trader. An allowance is made in respect of the replacement of obsolete machinery. A deduction in respect of the wear and tear of buildings which are used by their owner as mills, factories, etc., is also granted to the extent of one-sixth of their annual value.

Case II. — Income from professions and vocations is calculated upon the general lines described in Case I.

Case IV. — Income from securities out of the United Kingdom is brought into assessment on the full amount arising within the preceding year, whether or not the income has been received in the United Kingdom. But, in special circumstances—viz., if such income accrues to a person not domiciled in the United Kingdom, or a British subject who is not ordinarily resident in the United Kingdom—the amount brought into assessment is the amount which is received in the United Kingdom in the preceding year.

Case V. — Income from possessions (other than securities) out of the United Kingdom is brought into assessment on the preceding year basis. If the income arises from stocks, shares or rents, it is computed on the full amount arising within the preceding year whether or not the income has been received in the United Kingdom. But, subject to the same qualifications as is described under Case IV, income from other foreign possessions (*e.g.*, share of a business wholly carried on abroad) is computed on the amount actually received within the United Kingdom in the preceding year.

SCHEDULE E.

Income tax under Schedule E is charged on employments generally. The amount brought into assessment is, generally speaking, the full salary or other emoluments of the preceding year, though there are special provisions for new and ceasing employments.

Expenses wholly necessarily and exclusively incurred by an employee in the performance of his duties are deductible in arriving at the amount of emoluments assessable.

4. COMPUTATION OF TAX.

(a) RESIDENT INDIVIDUALS.

The following tabular statement will make clear the various stages of calculation of liability of an individual taxpayer—viz. :

1931-32. — Ascertain first the total income.
 Calculate tax at the standard rate (5s.) on total income.
 Deduct tax at the standard rate (5s.) on earned income allowance.
 Deduct tax at the standard rate (5s.) on personal and other allowances.
 The balance will equal tax at the standard rate on taxable income.
 Allow relief on £175, at one-half the standard rate, leaving tax chargeable on £175 at 2s. 6d. (one-half of 5s.) and on the remainder of the taxable income at 5s. (the standard rate).
 Deduct tax at the allowable rate on life insurance premiums and in respect of dominion income tax relief.
 The balance will be the tax payable.

The graduation of the income tax is effected by three factors, viz. :

- (a) By earned income, personal and other allowances and deductions of tax ;
- (b) By charging the first £175 of taxable income at one-half the standard rate and the balance remaining the full standard rate ;
- (c) By means of the surtax, applying to a total income exceeding £2,000 (see pages 179 to 181).

The effect of this system is that, if the total tax payable by any individual taxpayer is divided by his total actual income, the resulting effective rate of tax per pound of actual total income rises gradually from a fraction of a penny in the pound (on an investment income of £101) until, including the surtax, it closely approaches for the highest incomes a maximum

rate of 13s. 4d. in the pound. The amount of tax borne by any individual under this system of graduation depends upon the amount of the total income, the nature of the income (that is, whether it is drawn from earnings or investments), marital condition, family responsibilities, etc., and the effective rate of tax varies with each change in these factors.

More specifically, the amount of tax payable by any individual taxpayer is determined as follows. The total of the actual income from various sources as defined in pages 169 to 174 having been ascertained, income tax at the standard rate¹ on this amount is first calculated. From the tax so calculated, deductions of tax at the standard rate are allowed :

(a) On one-fifth of the earned income,² subject to a maximum of £300 ;

(b) In respect of various personal and other allowances. The principal allowances under this head are :

(i) £100 to an unmarried taxpayer ;

(ii) £150 to a married couple and, where the wife has earned income, an additional deduction of four-fifths of the amount of such earned income (subject to a maximum additional deduction of £45) ;

(iii) £50 to a widower or widow who has a female relative residing with him or her (or, if no willing relative can be found, employs some other woman) either (a) to take charge of his or her young children, or (b) in the capacity of housekeeper ;

(iv) £50 to an unmarried taxpayer in respect of his widowed mother (or some other female relative) if maintained by him and living with him for the purpose of taking care of his younger brothers and sisters ;

(v) £50 for the first child and £40 for each subsequent child under the age of 16 years or over 16 if they are still receiving full-time education ;

(vi) £25 in respect of any " dependent relative " who is incapacitated by old age or infirmity from maintaining himself and whose total income does not exceed £50 a year ; this allowance applies to a taxpayer's widowed mother or mother-in-law, whether she is incapacitated or not, and it applies also in the case of a taxpayer who, by reason of old age or infirmity, is compelled to depend upon the services of a daughter resident with and maintained by him.

All these allowances are made irrespective of the amount of the taxpayer's income.

The amount of income on which tax at the standard rate remains chargeable after making the allowances and deductions under (a) and (b) above is termed the taxable income. Relief is allowed on the first £175 of taxable income at five-ninths of the standard rate of tax, the effect being that tax for the year 1931-32 is charged on the first £175 of taxable income at 2s. 6d. in the pound (one half of 5s.—the standard rate) only and on the balance of the taxable income at 5s. in the pound.

Relief in Terms of Tax.

From the amount of tax so arrived at, there remains to be deducted any relief, expressed in terms of tax, due in respect of (a) premiums paid for life insurance or for contracts for deferred annuities, and (b) dominion income tax. The balance represents the amount of tax payable.

¹ The surtax applicable to individuals with total incomes exceeding £2,000 is calculated separately (see page 180).

² A taxpayer who is 65 years of age, or whose wife living with him is 65 years of age, can claim a deduction on one-fifth of the total income (earned or investment), provided the total income does not exceed £500.

The manner in which tax may be collected from a taxpayer partly at the source and partly directly, and the adjustments that may be necessary, are dealt with on pages 177 to 179 below.

Life Insurance.

An allowance of tax is authorised in respect of (a) premiums (whether annual or not) paid by the claimant for insurance on his own life or on that of his wife, (b) similar premiums (whether annual or not) paid by the claimant's wife out of her separate income on her own life or on that of her husband, and (c) any sums which the claimant, under any Act of Parliament or under the conditions of his employment, is liable to pay, or bear in order to secure a deferred annuity to his widow or provisions for his children after his death.

The allowance due is calculated at the following rates of tax :

(i) Where the policy was effected on or before June 22nd, 1916 :

(a) Normally at half the standard rate if the total income does not exceed £1,000 ;

(b) At three-fourths of the standard rate if the total income exceeds £1,000 but does not exceed £2,000 ;

(c) At the full standard rate if the total income exceeds £2,000.

Special marginal provisions may come into force when the total income is near the limit of £1,000 or £2,000.

(ii) Where the policy was effected after June 22nd, 1916, normally at half the standard rate.

The allowance is in all cases subject to the following limitations :

(a) The total amount on which the allowance is calculated is not in any case to exceed one-sixth of the claimant's total income from all sources for the year of claim.

(b) In the case of any policy securing a capital sum on death (whether in conjunction with any other benefit or not) the amount on which the allowance is calculated is not to exceed 7 per cent of that capital sum exclusive of any additional benefit by way of bonus or otherwise.

(c) In the case of policies or contracts which do not secure a capital sum on death, the total amount on which the allowance is calculated is not to exceed £100, and the policies must have been taken out not later than June 22nd, 1916. In the case of such policies or contracts effected after that date, no allowance is made, except where they were effected in connection with certain superannuation or pension schemes.

(d) In the case of a deferred assurance made after June 22nd, 1916, no allowance is made in respect of premiums payable during the period of deferment (except where the assurance was effected in connection with certain superannuation or pension schemes).

Dominion Income Tax Relief (excluding the Irish Free State) (see Pages 176 and 177).

Any person liable to United Kingdom income tax on any part of his income who proves that he has paid dominion income tax for the same year in respect of the same part of

his income is entitled to relief from United Kingdom income tax on that part of his income calculated at the lower of the two following rates—viz. :

- (a) The dominion rate of tax, or,
- (b) One-half that person's "appropriate rate of United Kingdom income tax".

The "dominion rate of tax" is determined by dividing the amount of the dominion income tax paid for the year by the amount of the income in respect of which the dominion income tax is charged for that year.

The "appropriate rate of United Kingdom income tax" in the case of a person whose income is not chargeable to United Kingdom surtax is a rate ascertained by dividing the amount¹ of income tax payable for the year in respect of his total income by the amount of that total income less the various amounts on which he may be entitled to relief for earned income allowance, personal allowance, housekeeper, children, dependent relatives, etc.; in the case of a person whose income is chargeable to United Kingdom surtax, it is the sum of the following rates :

- (a) The rate which would have been his appropriate rate if his income had not been chargeable to United Kingdom surtax, and,
- (b) The rate ascertained by dividing the amount of the surtax payable by him for the *preceding* year by the amount of his total income for such preceding year.

It may be noted that relief in respect of dominion income tax is granted, not only to individuals, but also to companies, which come within the scope of the provisions stated. Relief so granted to companies is passed on to their shareholders, so far as dividends are distributed, by a corresponding reduction of the standard rate of tax deductible from such dividends under the system of collection at the source (see pages 177 to 178). The Royal Commission on the income tax, upon whose recommendation this relief is founded, contemplated that any further relief, necessary in order to confer on the taxpayer relief amounting in all to the lower of the two taxes (United Kingdom or dominion), should be given by the dominion concerned.

Double Taxation Relief between Irish Free State and United Kingdom.

There are special provisions for relief from double income tax between the United Kingdom and the Irish Free State contained in two Agreements of April 14th, 1926, and April 25th, 1928, between the British Government and the Government of the Irish Free State.²

The principle of the Agreements is, shortly, that each country will :

- (a) Exempt from its income tax and surtax (either by non-collection of the tax or by repayment) income arising within its borders to persons who are not resident within its borders but are resident in the other country, and,
- (b) Grant relief from double taxation to persons resident in both countries in respect of income which is taxed by both.

As a corollary to (a), it is provided that United Kingdom income tax shall be charged in respect of all income arising in the Irish Free State to persons resident in the United Kingdom.

¹ This amount is not reduced by any relief granted in respect of life insurance premiums.

² The 1926 Agreement was confirmed, so far as the British Government is concerned, by Section 23 of the Finance Act, 1926, and is set out in Part I of the Second Schedule to that Act. The 1928 Agreement was confirmed by Section 21 of the Finance Act, 1928, and is set out in the Fourth Schedule to that Act.

The relief under (b) is given in accordance with and under Section 27 of the Finance Act, 1920 (the provision dealing with dominion income tax relief, see pages 175 and 176), subject to the following modifications :

(i) Each country will give relief at one-half of the lower of the taxpayer's two appropriate rates of tax, British or Irish Free State ;

(ii) For the purpose of determining the " appropriate rate ", the rate of income tax in each country will be ascertained, not by reference to taxable income, but by reference to total income ;

(iii) The surtax rate to be taken into account in ascertaining the appropriate rate is the surtax rate for the year for which relief is being given and not for the preceding year. It is provided that for the purpose of the Agreement a company is to be deemed to be resident in that country only in which its business is managed and controlled.

(b) NON-RESIDENT INDIVIDUALS.

The allowances, deductions and reliefs described in pages 174 to 175, with the exception of the relief in respect of dominion income tax, are not given to individuals who are not resident in the United Kingdom, and the whole of their income liable to United Kingdom income tax is chargeable at the full standard rate, subject to the qualification that these allowances and deductions are due, with certain modifications, where the individual satisfies the Commissioners of Inland Revenue that he or she :

(a) Is a British subject, or,

(b) Is a person who is or has been employed in the service of the Crown, or who is employed in the service of any missionary society or of any native State under the protection of His Majesty, or,

(c) Is resident in the Isle of Man or Channel Islands, or,

(d) Has previously resided within the United Kingdom and is resident abroad for the sake of his or her health or the health of a member of his or her family resident with him or her, or,

(e) Is a widow whose late husband was in the service of the Crown.

The effect of these modifications is to charge the income which is subject to tax in the United Kingdom (*i.e.*, broadly speaking, the British income) at the real effective rate which would have been levied if the total income from all sources (*i.e.*, British and non-British income) had been subject to tax in the United Kingdom.

5. COLLECTION OF THE TAX.

The peculiar distinction of the British income tax is collection at the source. Whenever it is possible to do so, tax is obtained by deducting it, before the income reaches the person to whom it belongs. Wherever possible, the formal assessment is laid, normally at the standard rate of tax, on each source of income by itself, and on persons who are debtors in respect of income belonging to other persons. Power is given to the payers of income to deduct the

appropriate tax (normally at the standard rate) from the payments made to the ultimate proprietors of that income.¹

For instance, instead of tax being collected directly from the various persons who may be interested in the rents arising from lands or buildings which are let, it is normally assessed on, and recovered from, the occupier of the property, who deducts it from the rent paid to his landlord. He, in his turn, if the property is encumbered with a mortgage or subject to a ground rent, may deduct the appropriate tax from the payments of those charges. Similarly, a limited liability company is assessed to tax at the standard rate on the whole of its profits, without reference to the ultimate destination of those profits. On paying interest to its debenture holders or dividends to its shareholders, the company is entitled to deduct and retain the amount of tax appropriate to the interest paid or dividend distributed, and the investor thus receives his interest or dividend subject to this deduction of tax at the standard rate.

The principal classes of income on which tax at the standard rate is collected by deduction at the source are the following :

Schedule A. — Rents, generally speaking, and all ground rents, lease rents, and similar payments arising out of immovable property ; mortgage and other interest secured on such property.

Schedule C. — All income charged thereunder.

Schedule D. — Dividends, debenture and other interest paid by limited liability companies ; interest and dividends payable by dominion and foreign companies through agents in the United Kingdom ; coupons for dividends payable abroad which are realised through a banker or coupon dealer in the United Kingdom ; patent royalties ; annual interest and annuities payable under contracts.

Schedule E. — Salaries of officers in the service of the Crown (including the navy, army, air force, civil service, etc.).

It is estimated that, in 1929-30, approximately 70 per cent of the net yield of the tax was collected at the source.

The chief classes of income in respect of which the tax is collected directly are the profits from trade (whether of individuals, partnerships, or limited liability companies) ; profits from the occupation of land ; income from professions and most employments ; income from dominion and foreign securities and possessions not paid through agents in the United Kingdom ; income from certain interest, discounts, etc.

The income of limited liability companies is charged in the assessments at the full standard rate of tax. Income on which tax is collected at the source is (with certain exceptions) similarly charged and tax is deducted from the income of the recipient at the full standard rate. The income of individuals upon which tax is collected directly is charged in the assessments

¹ There is a provision of the law (Rule 23, General Rules, Income Tax Act, 1918) which renders void any agreement for payment of interest, rent, or other annual payment without deduction of tax. This provision does not apply to dividends, but, where dividends are paid without deduction of tax, the law provides (Section 33 of the Finance Act, 1924) that the dividend warrant shall have annexed thereto or be accompanied by a statement in writing showing :

- (a) The gross amount which, after deduction of the income tax appropriate thereto, corresponds to the net amount actually paid, and,
- (b) The rate and the amount of income tax appropriate to such gross amount, and,
- (c) The net amount actually paid.

as far as possible, at the respective one-half standard and full standard rates on the taxable income. As the total actual income of any individual taxpayer may be made up of a number of separate items on some of which tax is borne by deduction at the source at the full standard rate and on others of which tax is collectible directly, adjustments are in numerous cases necessary in order to restrict the total tax payable to the amount proper to the actual circumstances of the individual concerned under the scheme of graduation and differentiation already described. These adjustments are made as far as possible when dealing with tax collected directly, any balance being dealt with by repayment of tax. They are greatly facilitated by the fact that personal statements of total income are required to be rendered annually by every individual taxpayer. In the case of individual taxpayers who are resident in the United Kingdom or who, if not so resident, fall within the classes mentioned on page 177, the effective rate of tax on each pound of actual total income only reaches the amount represented by the full standard rate of income tax when the total income exceeds £2,000 and the amount of surtax payable is also brought into account; but income accruing to non-residents who do not fall within the classes mentioned on page 177, and also income assessed on limited liability companies, corporations, etc., which is not distributed to shareholders, debenture holders, etc., remains finally liable to income tax at the full standard rate.

Income tax under Schedules A, B, D and E, which is contained in the main assessments for the year, is as a general rule due and payable on or before January 1st in the year of assessment; tax contained in additional assessments signed after that date is payable on the day after the date of signature. To this general rule there are, however, important exceptions. Tax charged on any individual or partnership under Schedule B in respect of lands occupied for husbandry only, tax charged on any individual or firm under Schedule D or E, in respect of a trade, profession or vocation, and of most employments, is payable in two instalments, the first amounting to three-quarters of the tax charged on or before January 1st in the year of assessment, and the second amounting to one-quarter of the tax charged on or before the following July 1st. Railway companies in England and Ireland pay tax under Schedule D in four quarterly instalments, on or before the 20th of June, September, December and March. Tax in respect of employments under the Crown is deducted at the source. Tax collected at the source under Schedule C and under Schedule D in respect of foreign dividends, etc., is paid at the time of payment of the income from which the tax is deducted.

6. SURTAX.

Under the scheme of simplification of the income tax and supertax introduced by Part III of the Finance Act, 1927, income tax and supertax were combined into one tax with one basis of assessment. The supertax, described as an additional duty of income tax, had been charged for any year of assessment on the individual's total income as computed for income-tax purposes for the preceding year. Under the new scheme it is imposed—under the name of surtax—upon the total income as computed for income-tax purposes for the year of assessment, and is so imposed as a deferred instalment of income tax for that year, payable on January 1st in the year following the year of assessment. Thus, for the year 1929-30, income tax is imposed both at the standard rate (payable either on January 1st, 1930, or in two instalments on January 1st and July 1st, 1930), and also at rates on a graduated scale exceeding the standard rate in respect of the excess over £2,000 of incomes which exceed that limit. The difference between the total amount of tax payable in respect of an income exceeding £2,000 and the amount which would have been payable if tax had been chargeable at the standard rate only is the deferred instalment of income tax which, under the name of surtax, was payable on January 1st, 1931.

For administrative reasons, surtax is assessed and collected separately from income tax, but it forms part of the general scheme of graduation for the direct taxation of incomes exceeding a fixed amount. The graduation of the income tax (described on page 174 above) is effected by freeing from tax the first sections of an individual's total income (by the grant of personal allowances and deductions) and by charging the taxable income, up to a maximum of £175, at one-half the standard rate of income tax, and the balance at the full standard rate. The surtax continues this process by imposing higher rates of tax on successive sections of the total income, when it exceeds a certain limit (at present £2,000).

The scale of surtax rates (*i.e.*, the rates in excess of the standard rate) in force for the year 1930-31 is as follows (the surtax for this year was payable on January 1st, 1932):

SURTAX CHARGED ON INCOMES OF INDIVIDUALS IN EXCESS OF £2,000.

Slice of income £	1930-31 basic surtax rates (to be increased by 10 per cent)	
	s.	d.
2,000 — 2,500	1	0
2,500 — 3,000	1	3
3,000 — 4,000	2	0
4,000 — 5,000	3	0
5,000 — 6,000	3	6
6,000 — 8,000	4	0
8,000 — 10,000	5	0
10,000 — 15,000	5	6
15,000 — 20,000	6	0
20,000 — 30,000	6	6
30,000 — 50,000	7	0
50,000	7	6

Section 7 of the Finance Act No. 2, 1931, having provided that the surtax rates, as determined by Part III of the Finance Act of 1927, should be increased by 10 per cent, in practice the amount due by the taxpayer is first worked out on the basis of the rates shown in the table and the resulting figure is then increased by 10 per cent (fractions of a penny being ignored in this final calculation).

As already stated in describing the scheme of graduation of the income tax, the effect of that scheme is to levy a real effective rate of tax on each pound of actual total income, rising gradually from a fraction of a penny in the pound to a maximum rate closely approaching 13s. 4d. in the pound.

Liability to surtax is not dependent upon the place of residence of the individual, and individuals resident out of the United Kingdom whose income, arising from sources within the United Kingdom, exceeds £2,000 are chargeable with surtax. Information is available to the revenue authorities of particulars of various items of income from United Kingdom sources (*e.g.*, income from property in the United Kingdom, dividends of United Kingdom companies, and the like), and if it seems likely that an individual resident abroad may have income from United Kingdom sources exceeding £2,000, he would be served with a form on which to return his total income from United Kingdom sources.

Surtax is collected directly from the individuals concerned. In the case of individuals resident abroad assessed to surtax, application for payment would be made to them in the ordinary course. If payment is refused, it is open to the revenue authorities to institute proceedings under the Crown Suits Act and after obtaining the judgment of the court, steps can be taken,

if necessary, to obtain a charge on any available assets of the individual in the United Kingdom in satisfaction of the outstanding surtax. It is, however, rarely necessary to resort to extreme measures of this kind in order to secure payment of the duty.

As surtax applies only to individuals (and not to companies) and as an individual's income from a company (as computed for surtax purposes) would normally consist of his share of the *distributed* income of the company, it was formerly open to an individual to avoid or limit his liability to tax by arranging that companies which he controlled should withhold from distribution the whole or a large part of their income. With a view to preventing this avoidance of tax, legislation had been passed providing that, where companies of the one-man type (*i.e.*, those controlled by a single individual or a small group of individuals) do not distribute a reasonable part of their income, the whole income of the company may, for purposes of surtax, be deemed to be the income of the shareholders and apportioned accordingly.

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

I. GENERAL PRINCIPLES.

A foreign enterprise,¹ whether an individual, a partnership, or a corporation, is, generally speaking, liable to United Kingdom income tax in respect of all income arising in the United Kingdom. There are three main exceptions to this general rule :

(a) The interest on certain United Kingdom Government securities issued in connection with the war is not liable to income tax so long as the securities are in the beneficial ownership of persons not ordinarily resident in the United Kingdom. (Section 46 of the Income Tax Act, 1918.)

(b) Irish Free State enterprises are not liable to United Kingdom tax in respect of income arising in the United Kingdom. (There is a similar exemption for United Kingdom enterprises from Irish Free State tax.)

(c) In certain cases, on a basis of reciprocity, dominion and foreign shipping enterprises are exempt, under Section 18 of the Finance Act, 1923, and Section 31 of the Finance Act, 1924, from United Kingdom income tax in respect of shipping profits arising in the United Kingdom.

Reciprocal exemption arrangements under this provision have been concluded with the following countries : United States of America, Norway, Sweden, Denmark, Finland, Netherlands, Germany, Iceland, Greece, Japan and Canada.

Negotiations for arrangements are proceeding with other countries.

The making of similar reciprocal exemption arrangements in relation to the profits of dominion and foreign air transport undertakings is authorised under Section 1 of Finance Act, 1931. No agreements under this provision have yet been concluded.

¹ Except where the context otherwise indicates or requires, the expressions " foreign enterprise " " foreign concern ", etc., are used in this report to denote an enterprise the management and control of which is centred abroad, while the expression " national enterprise ", " national concern ", etc. is used to denote an enterprise, wherever incorporated, the management and control of which is in the United Kingdom.

This reciprocal exemption is embodied in the Agreement of April 14th, 1926, between the British Government and the Government of the Irish Free State. The Agreement was confirmed, so far as the British Government is concerned, by Section 23 of the Finance Act, 1926, and is set out in Part I of the Second Schedule to that Act. (There was a further Agreement of April 25th, 1928, between the two Governments amending the 1926 Agreement in minor particulars. See the Fourth Schedule to the Finance Act, 1928.)

II. TAXATION OF CERTAIN ITEMS OF INCOME.

(a) *Dividends.*

Income tax at the standard rate is collected at the source from the payer who deducts tax on paying the dividends.

(b) *Interest.*

In the case of annual interest, income tax at the standard rate is collected at the source from the payer who deducts tax, on paying the interest. Examples of annual interest are interest on bonds, debentures, mortgages, etc. On the other hand, bank deposit interest¹ discounts on Treasury Bills, and certain items of "short" interest (*i.e.*, non-annual interest) are paid in full without deduction of tax, and are subject to direct assessment in the hands of the recipient. (If the foreign recipient of such interest has no branch or agent in the United Kingdom in whose name he can be assessed, the machinery of direct assessment is ineffective.)

(c) *Patent and Copyright Royalties and Other Income from Personal Property.*

Income tax at the standard rate is collected at the source from the payer of patent and copyright royalties, who deducts tax on paying the royalties to owners abroad.

(d) *Rents from Real Estate, Mining Royalties and Similar Income.*

Income tax at the standard rate is collected at the source from the occupier of the property or the mine, which deducts tax on paying the rent, mining royalties, etc.

(e) *Gains from the Purchase and Sale of Real Estate and Securities.*

No tax is chargeable except in cases where the foreign enterprise is carrying on, through an agent or branch in the United Kingdom, the business of dealing in real estate or securities. In that event, the foreign enterprise would be chargeable in the name of the agent or branch in respect of profits arising from such business.

(f) *Compensation for Personal Services—e.g., Salaries, Wages, Fees &c.—received by an Employee employed in the United Kingdom.*

If the employee is resident in the United Kingdom [(see page 168), he would be chargeable to income tax in respect of his total remuneration, whether earned in the United Kingdom or abroad. If he is not resident in the United Kingdom, he would be chargeable in respect of his earnings in the United Kingdom.

(g) *Income received from Trusts.*

The United Kingdom trust would normally be chargeable to income tax at the standard rate in respect of its income in the ordinary course, and the foreign enterprise would receive from the trust its share of the net income (normally after deduction of income tax at the standard rate). If the income of the United Kingdom trust included income from foreign sources, relief from income tax would be afforded to the extent that the foreign enterprise (or beneficiary) was specifically entitled to a share of this foreign income.

¹ In the case of a fixed bank deposit for a certain period where the interest is annual, income tax would be deductible by the payer of the interest.

(h) *Income from the carrying on of a Trade¹ or Business through Agents, etc.*

The broad rule is that the foreign enterprise would be chargeable to income tax in the name of the agent of permanent establishment in respect of profits of trading within the United Kingdom.

In the case of the sale of goods, when the contract of sale is made in the United Kingdom, the sale is deemed to take place here, and this would constitute trading within the United Kingdom.

A contract is not made by a customer giving to a seller or his agent an order from a price list. "An order given to a merchant for the supply of goods does not of itself create any obligation. Until something is done by the person receiving the order which amounts to an acceptance, there is no contract". (*Grainger & Son v. Gough*, 3 T.C., 465.² In that case, a French wine merchant appointed an English firm as his agents in England to canvass for orders. These orders were transmitted to their principal abroad, who exercised his discretion as to executing them. The wine was sold as lying in the foreign warehouse. Held that the contracts for the sale, and the deliveries of the wine, took place abroad, and that the French merchant did not exercise a trade within the United Kingdom.)

If an agent in the United Kingdom is authorised to sell goods at a limit of price and sells, the contracts are made in the United Kingdom. And if the agent (in the United Kingdom) obtains orders which are submitted to the foreign principal abroad "who then authorises the agent to make a contract accepting . . . equally that proceeding results in a contract made in England." (*Wilcock v. Pinto & Co.*, 9 T.C., 135. In that case a cotton merchant firm in Egypt appointed an agent in England. He received authority to sell specific quantities of cotton on terms as to price, etc., fixed by them on each occasion, and he also obtained offers to purchase cotton which he transmitted to them for acceptance or rejection. In both cases the contract, if made, was made by the agent in England. Held that the Egyptian firm were exercising a trade within the United Kingdom.)

The acceptance of an offer makes a contract when communicated to the other party, and if the communication is made in England the contract is made in England. (*Belfour v. Mace*, 13 T.C., 555.) Thus, if an agent posts in England his foreign principal's acceptance of an offer, the contract is made in England. (*Cavazzi v. Mace*, 10 T.C., 698; *Belfour v. Mace* 13 T.C. 539.) (In *Belfour v. Mace*, an Italian silk merchant appointed an agent in England who solicited orders and transmitted them to the principal in Italy. The latter reserved the right to refuse or accept the orders and to fix prices. Acceptances of orders were sent from Italy in duplicate to the agent who posted one copy to the customer. Held that the Italian principal was exercising a trade within the United Kingdom, the contracts being made in this country.)

Relief from Double Taxation on Certain Profits arising through an Agency. — Section 17 of the Finance Act, 1930,³ enables the British Government to enter into agreements with foreign States or the British dominions for the reciprocal exemption from income tax of profits arising to non-resident principals through resident agents. It is provided, however, that no

¹ The term "trade" is defined in Section 237 of the Income Tax Act, 1918, as including every trade, manufacture, adventure or concern in the nature of trade.

² The references are to reports of tax cases published by the Board of Inland Revenue.

³ Section 17 of the Finance Act, 1930, reads as follows:

"*Relief from Double Taxation on Certain Profits arising through an Agency.* — (1) Subject to the provisions of this section, if His Majesty in Council is pleased to declare:

"(a) That any profits or gains arising directly or indirectly to a person resident in any foreign State or in any part of His Majesty's dominions outside the United Kingdom through an agency in the United Kingdom or to a person resident in the United Kingdom through an agency in any foreign State or in any part of His Majesty's dominions outside

arrangements made under the Section shall exempt from United Kingdom income tax any profits which either :

- (a) Arise from the sale of goods from a stock in the United Kingdom, or,
- (b) Accrue to a person resident in the United Kingdom, or,
- (c) Accrue to a non-resident person directly or indirectly through any branch or management in the United Kingdom, or through any agency in the United Kingdom where the agent has and habitually exercises a general authority to negotiate and conclude contracts.

Negotiations are proceeding with several countries for the conclusion of reciprocal arrangements under this provision.

(I) *Income from the carrying on of a Trade or Business through :*

A Broker or General Commission Agent. — Normally no tax is chargeable. General Rule 10, Income Tax Act, 1918, provides that :

“ Nothing in these rules shall render a non-resident person chargeable in the name of a broker or general commission agent, or in the name of an agent not being an authorised person carrying on the regular agency of the non-resident person or a person chargeable as if he were an agent in pursuance of these rules, in respect of profits or gains arising from sales or transactions carried out through such a broker or agent.”

the United Kingdom are chargeable both to United Kingdom income tax and to income tax payable under the law in force in that foreign State or that part of His Majesty's dominions, and,

“(b) That arrangements as specified in the declaration have been made with the Government concerned with a view to the granting of relief from such double taxation, then, unless and until the declaration is revoked by His Majesty in Council, the arrangements specified therein shall, so far as they relate to the relief to be granted from United Kingdom income tax, have effect as if enacted in this Act, but only if and so long as the arrangements, so far as they relate to the relief to be granted from the income tax payable in the foreign state or in the part of His Majesty's dominions, have the effect of law in the foreign state or the part of His Majesty's dominions ;

“ Provided that no arrangements made under this section shall exempt from United Kingdom income tax any profits or gains which either :

“(i) Arise from the sale of goods from a stock in the United Kingdom, or,

“(ii) Accrue to a person resident in the United Kingdom, or,

“(iii) Accrue to a person not resident in the United Kingdom directly or indirectly through any branch or management in the United Kingdom or through any agency in the United Kingdom where the agent has and habitually exercises a general authority to negotiate and conclude contracts.

“(2) Any declaration made by His Majesty in Council under this section shall be laid before the Commons House of Parliament as soon as may be after it is made and, if an address is presented to His Majesty by that House within twenty-one days on which that House has sat next after the declaration is laid before it, praying that the declaration may be revoked, His Majesty in Council may revoke the declaration and the arrangements specified in the declaration shall thereupon cease to have effect, but without prejudice to the validity of anything previously done thereunder or to the making of a new declaration.

“(3) The obligation as to secrecy imposed by any enactment with regard to income tax shall not prevent the disclosure to any authorised officer of the foreign State or part of His Majesty's dominions mentioned in the declaration of such facts as may be necessary to enable relief to be duly given in accordance with the arrangements specified in the declaration.

“(4) In this section, the expression ‘ His Majesty's dominions ’ includes any territory which is under His Majesty's protection or in respect of which a mandate on behalf of the League of Nations has been accepted by His Majesty and is being exercised by the Government of some part of His Majesty's dominions.”

This rule is modified by Section 17 of the Finance Act, 1925,¹ which provides that a non-resident principal is not to be charged to income tax, in the name of his agent here, in respect of profits from business carried on in this country through the agent where that agent is a *bona fide* broker or general commission agent who carried out the transactions on behalf of the non-resident principal in the ordinary course of his business as a broker or general commission agent and who receives the customary commission for his services.

This provision is reflected in the corresponding provision in the draft conventions contained in the report by the Government experts on double taxation and tax evasion at Geneva in 1928.

(2) *A Travelling Salesman.* — Normally no tax is chargeable. (It is assumed that the travelling salesman merely canvasses for orders which he submits to his foreign principal, and that he does not conclude contracts in the United Kingdom. If the salesman concludes contracts in the United Kingdom, the foreign enterprise would be chargeable in the name of the salesman as agent in respect of profits of trading in the United Kingdom.)

(3) *An Agent with Power of Attorney.* — The foreign enterprise would be chargeable in the name of the agent in respect of profits of trading in the United Kingdom. (It is assumed that the agent does, in fact, conclude contracts in the United Kingdom.)

(4) *An Agent selling out of a Stock owned by the Foreign Enterprise.* — The foreign enterprise would be chargeable in the name of the agent in respect of profits of trading in the United Kingdom.

(5) *A Permanent Establishment of any Kind.* — The foreign enterprise would be chargeable in the name of the permanent establishment in respect of profits of trading in the United Kingdom.

B. NATIONAL ENTERPRISES.

I. GENERAL PRINCIPLES.

A national enterprise is, broadly speaking, liable to income tax in respect of all income arising from foreign sources. The one exception to this general rule is that income arising abroad from foreign possessions other than securities, stocks, shares and rents, is chargeable, not on the full amount of the income arising, but on the amount of the income received in or remitted to the United Kingdom.²

¹ Section 17 of the Finance Act, 1925, reads as follows :

“ (1) Where sales or transactions are carried out on behalf of a non-resident person through a broker in the ordinary course of his business as such, and the broker satisfies the conditions required to be satisfied for the purposes of this section, then notwithstanding that the broker is a person who acts regularly for the non-resident person as such broker, the non-resident person shall not be chargeable to income tax in the name of that broker in respect of profits or gains arising from those sales or transactions.

“ (2) The conditions required to be satisfied for the purposes of this section are that the broker must be a person carrying on *bona fide* the business of a broker in Great Britain or Northern Ireland, and that he must receive in respect of the business of the non-resident person which is transacted through him remuneration at a rate not less than that customary in the class of business in question.

“ (3) In this section the expression ‘ broker ’ includes a general commission agent.

“ (4) Rule 10 of the general rules shall have effect subject to the provisions of this section. ”

² Types of foreign income liable on the “ remittance ” basis only are income from a business controlled and carried on wholly abroad, and the salary of an employee employed wholly abroad and paid abroad.

II. TAXATION OF CERTAIN ITEMS OF INCOME.

(a) and (b) *Dividends and Interest*. — Income tax at the standard rate ¹ is collected at the source from bankers, etc., in the United Kingdom entrusted with the payment of interest or dividends on foreign securities, shares, etc., to, or collecting such interest or dividends on behalf of, persons in the United Kingdom. The bankers, etc., deduct tax on payment of the interest or dividends to their customers. Where persons in the United Kingdom receive interest or dividends on foreign securities, shares, etc., otherwise than through bankers, etc., in the United Kingdom (e.g., where the dividends are cashed abroad), they are required to include such items in their return of income for direct assessment to income tax. Apart from the ordinary examination of such returns by the inspector of taxes (e.g., comparison with returns of previous years, etc.) and any necessary enquiries from the taxpayer, there is no special check imposed as regards these items of income. Comparison with returns for death-duty purposes on the taxpayer's death would usually reveal any discrepancy on the returns. Information would also often be available as to the actual dividends paid by important companies abroad.

(c) *Patent and Copyright Royalties and Other Income from Personal Property*. — A person resident in the United Kingdom who is carrying on the profession of author or inventor would be chargeable with tax in respect of all foreign copyright or patent royalties. Other persons in the United Kingdom receiving such income would normally only be liable on the basis of the income actually received in or remitted to the United Kingdom.

(d) *Rents from Real Estate, Mining Royalties and Similar Income*. — Rents from foreign real estate are liable to income tax on the basis of the full income arising. Income from mining royalties, etc., is only liable to the extent that it is received in or remitted to the United Kingdom. There is no special check imposed as regards items under (c) and (d). The ordinary examination and comparison would be made as indicated under (a) and (b) above.

(e) *Gains from Purchase and Sale of Real Estate and Securities*. — Not liable to income tax except in cases where the national enterprise is carrying on the business of dealing in real estate or securities. In such cases the procedure would be the same as in (h) below.

(f) *Compensation for Personal Services—e.g., Salaries, Wages, Fees, etc., received by an Employee employed wholly Abroad*. — If the employee is resident in the United Kingdom (see page 168) he would be chargeable to income tax in respect of his total remuneration, if the remuneration was, wholly or in part, paid here, but would only be chargeable on the amount of the remuneration that was remitted to the United Kingdom, if it is paid wholly abroad.

If the employee is not resident in the United Kingdom, he would not be chargeable in respect of remuneration from his employment abroad.

(g) *Income received from Trusts*. — A national enterprise would be liable to income tax in respect of income received from a foreign trust. The computation of the liability—whether on the national enterprise's share of the full income arising to the foreign trust, whether remitted to the United Kingdom or not, or on the income actually remitted to the United Kingdom—would depend upon the circumstances of the particular case. The question turns upon the law of trusts in the country in which the foreign trust is situated. The point at issue is this—is the United Kingdom beneficiary entitled, under the appropriate foreign law of trusts, to a share

¹ In certain cases, dominion income tax relief is given at the source and tax would be collected at a correspondingly reduced rate.

of the dividends on specific stocks and shares (the trust investments), in which case he would be liable to United Kingdom tax on the full amount of such income arising to the foreign trust, whether remitted to the United Kingdom or not, or is he merely entitled, under the foreign law, to a share of the general trust income (and not to a share of the dividends on specific stocks and shares), in which case he would be liable on the income actually remitted to the United Kingdom. In the case of *Garland v. Archer-Shee*, the position was that, under the relevant American law, Lady Archer-Shee "had no right to any specific dividends or interest at all" and that what she "got was what came to her from a foreign possession—namely, her right to get the trustees to make payment to her of the balance of the income", and it was held that the basis of liability to United Kingdom tax was the income actually remitted to the United Kingdom.

(h) *Income from the carrying on of a Trade or Business through Agents.* — A national enterprise is liable to income tax in respect of all income from trading operations abroad. In the case of a partnership, with partners resident in the United Kingdom and abroad, the liability would normally be restricted to the share of the income arising abroad attributable to the partners resident in the United Kingdom. Accounts covering the whole of the trading operations, including those carried on abroad, would be required, and these would be analysed in the ordinary course and the profits ascertained in accordance with the provisions of the United Kingdom income tax law.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

1. *Income from Sources other than Trade.* — 1. So far as foreign enterprises¹ receive income from this country other than from trading operations (*e.g.*, rents, interest, dividends of United Kingdom companies, etc.), there is usually no problem of allocation or apportionment, the income from non-trading sources being separate and its amount easily ascertained. So far as possible, income tax at the standard rate on such items of income is collected at the source, the tax being charged in the first place on the United Kingdom payer of the interest, dividends, etc., who is entitled to deduct the appropriate tax on making payment of the interest, dividends, etc., to the foreign enterprise. In this connection, reference may be made to Part II.

2. *Income from Trade.* — 2. The problem of apportionment arises in cases where foreign enterprises engage in trading operations in the United Kingdom and receive profits or income from that source. In such cases, the foreign enterprise is liable to United Kingdom income tax in respect of profits derived from the trading operations in the United Kingdom.

A foreign enterprise may carry on trading operations in the United Kingdom (*a*) through an agent, or (*b*) through a branch, or (*c*) through a subsidiary company controlled by the foreign enterprise. In all these cases, the problem before the United Kingdom taxation authorities is to ascertain the amount of the profits derived from the trading operations in the United Kingdom. Three methods of ascertainment of the profits are employed :

- (a) Separate accounts (the general and most satisfactory method) ;
- (b) Percentage of turnover, and,
- (c) Other conventional methods.

The income of the branch or subsidiary company is determined separately, as a general rule. The accounts would be analysed, with particular reference to interlocking transactions (*e.g.*, the costing of goods between the foreign enterprise and the United Kingdom branch or company). In some cases, a comparison would be made with the profits of similar British businesses. Reference may be made to what is said below under "*Method of Separate Accounting*".

Normally, the income of the branch or subsidiary company is not determined as a fraction of the income of the foreign company, and it is usually unnecessary to determine the income of the parent company. In some cases, the United Kingdom profits are taken as a percentage of the United Kingdom turnover, and, in those cases, it may be necessary to ascertain the total turnover and total profits of the parent company in order to fix the

¹ Except where the context otherwise indicates or requires, the expression "foreign concern", "foreign enterprise", etc., is used in this report to denote an enterprise the management and control of which is centred abroad, while the expression "national concern", "national enterprise", etc., is used to denote an enterprise, wherever incorporated, the management and control of which is in the United Kingdom. (See also the footnote to paragraph 3 of Part I.)

appropriate percentage of the United Kingdom turnover which should be taken. The profits of the parent company would be ascertained from the company's accounts, the accounts being examined in the ordinary way and the profits computed in accordance, so far as is possible, with the provisions of the United Kingdom income-tax law.

(a) METHODS OF ALLOCATION.

1. *Method of Separate Accounting.*

A separate account¹ of the United Kingdom establishment showing the profits from trading operations in the United Kingdom is normally required in every case at the outset. In a fair number of cases (chiefly those where the United Kingdom trading operations are separate and distinct from the foreign operations, *e.g.*, where a separate manufacturing business is carried on by the United Kingdom establishment, the raw materials being obtained from an independent source) there is usually no difficulty in ascertaining the United Kingdom profits on the basis of accounts furnished.

In many cases, however, where separate accounts are produced there is considerable difficulty in ascertaining the amount of the United Kingdom profits, chiefly owing to the interlocking transactions between the foreign enterprise and the United Kingdom establishment. The principal trouble arises where goods are manufactured abroad by the foreign enterprise and are sent to this country for sale by the United Kingdom establishment, and the main question that gives rise to trouble is, At what price should the goods be included in the accounts of the United Kingdom establishment?

In dealing with this question it is important to have a clear understanding of the course of business between the foreign enterprise and the United Kingdom establishment and to know the basis actually adopted in transactions between them. For this purpose, it is helpful, in particular cases, to have a copy of the current account between the foreign enterprise and the United Kingdom establishment, or a detailed analysis of the interlocking transactions (indicating clearly the basis adopted for internal accounting purposes).

Owing to the infinite variety of circumstances, it is impossible to lay down any universal rule as to the basis which should be followed in invoicing goods between the foreign enterprise and the United Kingdom establishment. In some cases, it is possible to take the figure at which similar goods are sold by the foreign enterprise to an independent customer in the United Kingdom under conditions that are customary in the particular trade, in others to take an independent market quotation for similar goods. Such tests fail if there are no sales to independent customers or the goods dealt in are of a specialist kind, but other lines of negotiation are in practice open to enable agreement to be reached as to the basis of costing the goods.

For example, an attempt might be made to ascertain the actual or approximate cost of the goods sold in the United Kingdom. (The costing system of the trader might enable this to be ascertained). As the sale price of the goods in the United Kingdom is known, negotiations might proceed in the direction of fixing an intermediate price for the invoicing of goods, attributing a certain percentage of the profits to the manufacturing process abroad and the balance to the merchanting business in the United Kingdom. (The relative percentages

¹ No particular form of account is prescribed by the Income Tax Acts. If the true profits cannot be readily calculated from the accounts submitted, the inspector of taxes would institute further enquiries with a view to reaching agreement with the taxpayer as to the amount of the profits.

attributable to manufacturing and merchanting would depend on the particular business and processes, but comparison would sometimes be possible with the corresponding results of similar businesses.)

A comparison of profits of similar businesses might enable the revenue authorities to criticise a particular invoice price as resulting in inadequate profits for the class of business done, and the taxpayer might agree, after negotiation, to substitute a revised price.

Generally, where the revenue authorities and the taxpayer are in disagreement, an attempt is made to hammer out a compromise, and this is frequently successful. The fact that the revenue authorities have the alternative of basing profits on a percentage of turnover prevents the taxpayer taking up an unreasonable attitude. In default of agreement, an assessment might be raised on an estimated figure of profits and the onus would then be on the taxpayer to prove that this assessment was excessive.

Apart from this main difficulty as to the basis of invoicing goods, minor difficulties are also experienced as to the allocation of head office expenses and overhead charges, etc. These are, however, usually capable of adjustment, and, where the main difficulty has been satisfactorily solved, it rarely happens that these items cause any serious trouble.

2. *Percentage of Turnover Method.*

It is estimated that some 55 per cent of the total cases are settled on the basis of separate accounts, usually after negotiation on the points referred to in the preceding paragraphs. In the remaining cases, either separate accounts cannot be furnished at all, or, where accounts are furnished, agreement cannot be reached as to the true amount of the United Kingdom profits.

In any case, where the true amount of the profits cannot be readily ascertained, the income-tax law (Income Tax Act, 1918, General Rule 8¹) allows the taxation authorities to charge the foreign enterprise on a percentage of the turnover of the business done by the foreign enterprise through or with the United Kingdom establishment. This basis is resorted to in about 20 per cent of the total cases.

The practical working of the "percentage of turnover" method differs with different types of case. If the United Kingdom establishment is an important branch of the foreign enterprise an attempt is usually made to obtain particulars of the total profits and total turnover of the enterprise, so as to ascertain the percentage applicable to the whole concern. Then, if the United Kingdom establishment is engaged in activities similar to those of the foreign enterprise (*e.g.*, merchanting only, or, on the other hand, both manufacturing and selling a particular product), the percentage ascertained for the whole concern is taken and applied to the United Kingdom turnover. If, on the other hand (as more frequently happens), the

¹ General Rule 8, Income Tax Act, 1918, reads as follows :

"Where it appears to the commissioners, by whom the assessment is made or, on any objection or appeal, to the general or special commissioners, that the true amount of the profits or gains of any non-resident person chargeable with tax in the name of a resident person cannot in any case be readily ascertained, the commissioners may, if they think fit, assess and charge the non-resident person on a percentage of the turnover of the business done by the non-resident person through or with the resident person in whose name he is chargeable as aforesaid and in such case the provisions of this Act relating to the delivery of statements by persons acting on behalf of others shall extend so as to require returns to be given by the resident person of the business so done by the non-resident person through or with the resident person, in the same manner as statements are to be delivered by persons acting for incapacitated or non-resident persons of profits or gains to be charged."

United Kingdom establishment is concerned only with merchanting¹ the product, the manufacture being carried on abroad, the percentage to be taken is normally less than the percentage for the whole concern (which covers both the manufacturing and the merchanting profit), the precise fraction depending on the nature of the business. In agency and small branch cases where information is not available as to the total results of the enterprise, the percentage of turnover would be determined by comparison with the results of similar United Kingdom enterprises engaged in the same class of business (or with similar non-resident concerns for which a percentage had already been ascertained).

The "percentage of turnover" method is applied mainly to manufacturing, producing and merchanting concerns. As a rule the percentage is fixed for each individual business, but in one or two instances where a class of trade is confined to a particular area, a common percentage has been taken for a number of concerns engaged in that trade under similar conditions. Generally, when a percentage has once been fixed, it is continued for a number of years, but in a few exceptional instances a fresh computation is made every year.

3. *Other Conventional Methods.*

In certain types of case where both the separate accounting method fails owing to interlocking transactions, etc., and it is not possible, owing to the nature of the business (*e.g.*, banks, insurance companies, etc.), to apply specifically the "percentage of turnover" method, it is usual for some other appropriate conventional method to be adopted (*e.g.*, in the case of banks, the proportion of the total profits which the United Kingdom assets bear to the total assets is sometimes adopted). These conventional methods, which are applied to some 25 per cent of the total cases, are referred to in greater detail on page 196.

It need only be added that, whichever method is adopted, the object of the United Kingdom taxation authorities is the same—*i.e.*, to arrive at the true, or, failing that, the best possible, computation of the profits made in the United Kingdom by a foreign enterprise.

4. *Requirements for Selection and Comparative Value of the Various Methods.*

The separate accounting method is considered to be most satisfactory. Where there are no interlocking transactions between the main enterprise and the branch establishment, no difficulty is experienced in determining the profits from the accounts. Where there are interlocking transactions, it is necessary to have a clear understanding of the course of business between head office and branch and to know the basis adopted in transactions between them

¹ General Rule 12 of the Income Tax Act, 1918, provides that where a United Kingdom establishment of a foreign enterprise is engaged in the sale of goods manufactured abroad by the foreign enterprise the assessment to United Kingdom tax may be restricted to the amount of the "merchanting" profit. The Rule reads as follows :

"Where a non-resident person is chargeable to income tax in the name of any branch, manager, agent, factor or receiver in respect of any profits or gains arising from the sale of goods or produce manufactured or produced out of the United Kingdom by the non-resident person, the person in whose name the non-resident person is so chargeable may, if he thinks fit, apply to the commissioners by whom the assessment is made, or, in the case of an appeal to the general or special commissioners, to have the assessment to income tax in respect of those profits or gains made or amended on the basis of the profits which might reasonably be expected to have been earned by a merchant or, where the goods are retailed by or on behalf of the manufacturer or producer, by a retailer of the goods sold, who had bought from the manufacturer or producer direct, and on proof to the satisfaction of the commissioners concerned of the amount of the profits on the basis aforesaid, the assessment shall be made or amended accordingly".

(e.g., on what basis goods have been invoiced between them, how head office expenses have been allocated, etc.). Given this information it is usually possible for the authorities and the taxpayer to reach agreement as to the treatment of these transactions, and the profits can then be satisfactorily ascertained from the accounts.

Where agreement cannot be reached and the separate accounting method fails, the "percentage of turnover" method is most frequently adopted. This, it is suggested, is the most convenient alternative method for manufacturing and merchanting businesses, where a "turnover" test, taking one year with another, is likely to give fairly satisfactory results.

Where the separate accounting method has failed and the "turnover" method cannot be applied owing to the nature of the business (e.g., banks, insurance companies, etc.), the best available method for the particular industry is followed (e.g., an assets basis for banks, a premium basis for insurance companies, a train mileage basis for railways, a freight basis for shipping, etc.). In the absence of any better evidence, these are likely to give fairly satisfactory results, taking one year with another, and it is certainly an advantage to have some definite method agreed between the taxpayer and the revenue authorities.

(b) APPORTIONMENT BETWEEN BRANCH AND PARENT ENTERPRISES.

1. *Apportionment of Gross Profits of Local Branch to Real Centre of Management Abroad.*

The concern is assessable on the full profits arising from trading operations within the United Kingdom, and none of the profits are ascribed to the real centre of management in a foreign country.

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest Charges.

When a company has a debenture debt, the question whether the charge on this debt is to be ascribed solely to the real centre of management or is to be distributed between the different permanent establishments does not arise, as debenture interest is not admitted as a deduction in determining the amount of the assessable profits. (Income Tax Act, 1918, Schedule D, Rule 3 (1) of the Rules applicable to Cases I and II.¹) (This provision prohibiting any deduction in respect of annual interest, etc., ensures collection of tax at the source on the full profits, and on paying the annual interest, etc., a company would normally be entitled to deduct income tax at the standard rate and thus pass on the burden of the tax in respect of the interest to the recipient of the interest.)

General Overhead Expenses.

Normally, in the case of manufacturing concerns abroad, the invoice price of goods to a branch in the United Kingdom would be so fixed as to cover a proportion of head office expenses and overhead charges, and there would be no question as to specific allocation of such expenses. In the few cases where specific allowance is given, the method usually followed is to apportion the overhead expenses by reference to turnover or some other factor which is appropriate to the particular case.

¹ Rule 3 (1), Cases I and II, Schedule D, Income Tax Act, 1918, reads as follows :

" In computing the amount of the profits or gains to be charged, no sum shall be deducted in respect of :

" (1) Any annual interest or any annuity or other annual payment payable out of the profits or gains ".

Even in non-manufacturing cases (*e.g.*, banks, insurance companies, etc.), specific claims to deduct a proportion of such expenses are exceptional. Where the concerns are assessed on a conventional basis (*e.g.*, a premiums basis for insurance companies or an assets basis for banks; see page 196 below) the overhead expenses would usually be taken into account in arriving at the total profits of the concern, and consequently in arriving at the appropriate United Kingdom proportion. Specific allowance has been given in the case of a few insurance companies on a premium proportion basis, while banks have occasionally been dealt with on the basis of allowing such a proportion of overhead expenses as the London branch expenses bear to the expenses of all branches.

3. *Apportionment of Net Profit.*

Apportionment of Branch's Net Profit to a Parent in Deficit.

When the branch or subsidiary company operates at a profit, whereas the entire concern operates at a loss, no cognisance is taken of the loss in determining the income of the branch or subsidiary company and one is solely concerned to ascertain the amount of the profits of the branch or subsidiary company.

Apportionment of Parent's Net Profit to a Branch in Deficit.

When the branch or subsidiary company in the country operates at a loss the fact that the entire enterprise realises a profit is immaterial. (It is assumed that the accounts of the branch or subsidiary company are genuine, and that the loss is a *bona fide* one.)

(c) SUBSIDIARY COMPANIES.

Under United Kingdom law, a subsidiary company is a separate legal entity from the parent company, and is normally dealt with separately for income-tax purposes. Separate accounts are required and these are analysed in the ordinary course with a view to arriving at the profits for income-tax purposes.

Where, however, owing to the close connection between the subsidiary company and the foreign parent company and the substantial control exercised by the parent company, the course of business is so arranged (*e.g.*, by manipulation of the price of goods between parent and subsidiary) that the subsidiary shows profits less than might be expected to arise from the subsidiary's business, there is a special provision (Income Tax Act, 1918, General Rule 7¹) which enables the taxation authorities to charge the foreign parent company, through the subsidiary as agent, upon the true profits. Where this rule is invoked, the "percentage of turnover" method is usually resorted to in order to determine the profits as in ordinary agency and branch cases (see pages 191 and 192).

¹ General Rule 7, Income Tax Act, 1918, reads as follows :

"Where a non-resident person, not being a British subject or a British, Indian, dominion, or colonial firm or company, or branch thereof, carries on business with a resident person, and it appears to the commissioners by whom the assessment is made that, owing to the close connection between the resident person and the non-resident person, and to the substantial control exercised by the non-resident person over the resident person, and to the substantial connection between these persons can be so arranged, and is so arranged, that the business done by the resident person in pursuance of his connection with the non-resident person produces to the resident person either no profits or less than the ordinary profits which might be expected to arise from that business, the non-resident person shall be assessable and chargeable to tax in the name of the resident person as if the resident person were an agent of the non-resident person".

II. APPLICATION OF THE METHODS OF ALLOCATION IN SPECIFIC CASES.

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

1. *Selling Establishments.**Local Establishments selling in National Markets.*

If a foreign enterprise sells through a branch in the United Kingdom, the whole profits of the concern in connection with the things so sold are assessable to United Kingdom tax. In the case of goods manufactured or produced abroad by the foreign concern, the assessment may be made at the option of the taxpayer on the basis of the "merchandising" profit. (Income Tax Act, 1918, General Rule 12.) For further details, see pages 190 to 192.

Local Establishments of Foreign Enterprises selling abroad.

In the case of a company, with its head office in one State, having a branch in the country which makes sales in a third State without having there a permanent establishment, the profits derived from sales in the third State are liable to United Kingdom tax if the business is managed and controlled in the United Kingdom. If the business is managed and controlled abroad, there would normally be no liability in respect of profits from sales in the third State.

2. *Manufacturing Establishments.*

In the case of foreign enterprises manufacturing in this country and selling elsewhere, a profit may be ascribed to the manufacturing establishment. Cases of this kind are extremely rare, and there is no specific provision of the law dealing with the question of liability and no decided cases in the courts bearing on the point. The question was considered by the Royal Commission on the Income Tax which reported in 1920. The paragraph of the Commission's report dealing with this point reads as follows :

"When an assessment is raised in the name of a British resident agent on the profits made by his foreign principal who sends manufactured goods to his agent for sale in this country, the non-resident may (under the provisions of Rule 12 of the general rules, Income Tax Act, 1918) make application that only the merchandising profit shall be assessed. We approve of the principle of a division of the profit into manufacturing profit and merchandising profit, and we consider that the converse of this rule should apply to the British resident agent of a foreigner who purchases goods in this country, subjects them here to processes akin to the processes of manufacture, and eventually sends them to his principal abroad. It would then be possible for the foreign principal to make application that the profits assessed in this country should be the manufacturing profit as distinct from the merchandising profit which he makes by selling the goods abroad."

3. *Buying Establishments.*

In the case of foreign enterprises continuously buying in the country through a permanent establishment, but selling in another country, none of the profits are ascribed to the buying establishment. It was decided in the case of *Sulley v. Attorney-General* (2 T.C., 149) that mere buying in the United Kingdom by a foreign enterprise did not constitute trading within the United Kingdom, and that the foreign enterprise was not liable to tax.

Foreign enterprises purchasing raw materials from other companies in this country with a view to manufacturing and selling elsewhere are not taxable on a presumed profit, for the same reason as above—that mere buying is not regarded as constituting trading within the United Kingdom.

4. *Research and Statistical Bureaux, Display Rooms, etc.*

If an enterprise has an establishment in the country which does not directly engage in any profit-making transactions but renders services to the enterprise which contributes indirectly to the realisation of profits—*e.g.*, a statistical bureau, or a display room—no profits are ascribed to it, as there are no sales in the United Kingdom and no profits from trading there, and consequently no liability to tax.

(b) OTHER KINDS OF ENTERPRISES.

(1) *Banks and Banking Companies.* — In about two-thirds of the cases, the United Kingdom establishment is assessed on the basis of separate accounts. In the remaining one-third, owing to interlocking transactions between head office and branch (*e.g.*, gross credits and debits, intricate interest adjustments, etc.), the separate accounting method cannot be followed, and the United Kingdom profits are determined as that proportion of the total profits which the United Kingdom assets bear to the total assets. This conventional method involves difficulties as to which are United Kingdom assets and which foreign assets, but these are usually capable of adjustment after negotiation.

(2) *Fire Insurance.* — The United Kingdom establishment is assessed on the basis of separate accounts.

(3) *Life Insurance.* — The United Kingdom establishment is normally charged on such a proportion of the company's total income from the investments of its life insurance fund as the United Kingdom premiums (*i.e.*, the premiums received from United Kingdom policy-holders and also from foreign policy-holders whose proposals were made at or through the United Kingdom establishment) bear to the total premiums received by the company, less a corresponding proportion of the total management expenses of the company.

(4) *Rail-road, Motor-bus and Other Transport Companies.* — The number of cases is very small. In the case of one or two steamship companies, the United Kingdom profits have been taken to be such a proportion of the total profits as the United Kingdom receipts bear to the total receipts (*i.e.*, a turnover basis). A similar basis has been adopted provisionally in the case of one of the air lines.

(5) *Power and Light, and Gas Companies.* — No cases known.

(6) *Telegraph and Telephone Companies.* — In one case, the United Kingdom profits have been taken to be such a proportion of the total profits as the United Kingdom receipts bear to the total receipts. In another case, the United Kingdom profits have been based on United Kingdom receipts, less expenses relating exclusively to the United Kingdom, plus a proportion of the overhead expenses (*i.e.*, those not relating exclusively to a particular country), the United Kingdom proportion being arrived at on a "user" basis ("user" being determined by the number of words sent out).

(7) *Mining and Extractive Industries.* — No cases known.

B. NATIONAL ENTERPRISES WITH BRANCHES OR SUBSIDIARIES ABROAD.

I. GENERAL METHODS OF ALLOCATION.

National enterprises are, generally speaking, chargeable with income tax in respect of their total profits from all sources, and there is normally no problem of apportionment between United Kingdom profits and foreign profits. The point does, however, arise in certain circumstances where an enterprise is carrying on trading operations both in the United Kingdom and abroad. For example, in the case of a partnership, with some partners resident in the United Kingdom and some abroad, the income-tax liability is normally based on the United Kingdom profits, plus the share of the foreign profits attributable to the partners resident in the United Kingdom.

It is thus necessary, in this particular type of partnership, to determine separately the United Kingdom profits and the foreign profits. In most cases, separate accounts can usually be furnished and the United Kingdom and foreign profits determined separately from the accounts (except where there are intricate interlocking transactions). Where the separate profits cannot be readily ascertained, the "percentage of turnover" method might be resorted to as in the converse case of the foreign enterprise carrying on trading operations in the United Kingdom.

Apart from these cases of partnerships, the problem of apportionment arises in connection with national enterprises carrying on trading operations in the Dominions (other than the Irish Free State). In their case, the object of the apportionment is to determine the amount of the dominion profits liable to both United Kingdom and dominion tax, in order that the relief from double taxation granted by section 27 of the Finance Act, 1920, may be computed. Separate accounts of the dominion trading are usually obtained, but in some cases it is necessary to apply the "percentage of turnover" or other conventional methods.

Generally, where the "percentage of turnover" method is applied, the same procedure is followed as in the converse case of the foreign enterprises (see pages 191 and 192).

Examples are given below of cases where other conventional methods have been applied :

(1) *Shipping Profits.* — The profits arising at a particular dominion port are usually ascertained by taking such a proportion of the total shipping profits of the enterprise as the freights obtained at that particular port bear to the total freights for the accounting period concerned.

(2) *Railways.* — The problem of apportionment does not often arise, but, in a few instances, it has been found satisfactory to divide the profits (*e.g.*, between one State or province and another) on a train-mileage basis in the area concerned.

(3) *Insurance Companies.* — Where the dominion profits cannot be satisfactorily ascertained from accounts owing to the ramifications of the companies concerned (*e.g.*, as regards investments, re-insurances, etc.), it has usually been found satisfactory to take such a proportion of the total profits as the dominion premiums bear to the total premiums.

(4) *Banks.* — The method most usually adopted is to take such a proportion of the total profits as the dominion assets bear to the total assets.

II. ALLOCATION OF PROFIT TO REAL CENTRE OF MANAGEMENT IN THE COUNTRY.

When a company has its real centre of management in the country but its other operations (for example, manufacture) in another country, the whole profits of the company are chargeable in the United Kingdom.

C. HOLDING COMPANIES.

I. NATIONAL HOLDING COMPANY CONTROLLING ONE OR MORE FOREIGN SUBSIDIARY COMPANIES.

The national holding company would normally be assessable only in respect of its own profits (including any dividends received from the subsidiary companies). In the exceptional case where the subsidiary company was a mere simulacrum or an agent of the holding company, the latter would be assessable in respect of the total profits (including the whole profits of the subsidiary).

II. LOCAL SUBSIDIARY COMPANY UNDER THE CONTROL OF A FOREIGN HOLDING COMPANY.

The local subsidiary company would be assessable on its own separate profits, and separate accounts would be required. Where the foreign holding company is also a trading company and the relations between the subsidiary company and the holding company are such that the accounts (of the subsidiary) do not show the true profits, the foreign company may be charged, through the subsidiary company as agent, on the true profits. (Income Tax Act, 1918, General Rule 7.) (See also page 194.)

D. DIFFICULTIES AND RECOMMENDATIONS.

Owing to the principles underlying the United Kingdom tax, no difficulties of an international character arise, if, by this expression, are meant difficulties between the United Kingdom revenue authorities and the revenue authorities of a foreign country.

**TAX SYSTEM AND ALLOCATION METHODS
IN THE UNITED STATES OF AMERICA**

by

JOSEPH WEARE

Audit Review Division, United States Treasury Department

and

M. L. McMORRIS

Rules and Regulations Section, Bureau of Internal Revenue, United States Treasury Department.

PART I. — GENERAL DESCRIPTION OF INCOME TAX SYSTEM.

Foreign enterprises deriving income from United States sources and American enterprises are subject to the Federal income tax imposed by the Revenue Act of 1928,¹ and still in effect. An authorized interpretation of the income tax provisions of the Act and rules prescribed by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury are contained in Regulations 74.

The purpose of Part II is to describe the manner in which foreign enterprises are taxed on income from United States sources, and how American enterprises are taxed on income from foreign sources, as well as the measures incorporated in the Act to relieve American enterprises from the United States tax when they have been subjected to tax abroad on their foreign income.

The methods employed in allocating the items of income or deductions of enterprises to the United States or abroad are discussed in Part III.

Before discussing these special questions, however, it is well to have in Part I, as a background, a description of the general principles and structure of the United States income tax system.

The income tax comprises a normal tax and surtax on individuals, estates and trusts, and a tax on corporations. A special tax is imposed on insurance companies, which will be described separately.

I. TAXPAYERS.

Citizens and Aliens.

With regard to citizens of the United States, the income tax is a purely personal tax, and is levied on their total net income from all sources regardless of where the citizen is resident, and even if all his income is from foreign sources. The liability of aliens depends on their place of residence, those resident in the United States being assimilated to citizens and, therefore, taxable on total net income from all sources (Art. 13). Aliens resident without the United States, however, are taxable only on income from sources within the United States (Sec. 212(a)).

Residence. — An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient or not is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States (Art. 1022).

¹ The term "Sec." or "Section" will be used in this memorandum to refer to sections in the United States Revenue Act of 1928, approved May 29th, 1928, and the term "art." or "article" to refer to articles in Regulations 74, concerning the income tax. For other abbreviations, see the list at the end of the memorandum.

Source. — The term “source” means the place of origin of the income and is not restricted to the place where payment is made, since the place of payment may be arbitrarily selected without relation to the nature of the transaction and is not indicative of the source. Where the income grows out of a business activity in the United States, it is immaterial where actual payment is made (O.D. 651, C.B., No. 3, July-December 1920, page 265). The circumstances in which business activities constitute a source of income are defined more fully under Part II.

Partnerships, Estates, Trusts.

— The tax imposed upon individuals applies in the case of income of partnerships, of estates, and of any kind of property held in trust.

A partnership is not a taxable entity (Sec. 181). The individual members of a partnership are taxable with respect to their distributive shares, whether distributed or not, of the net income of the partnership. Accordingly, citizens or residents of the United States who are members of a partnership are taxable with respect to their distributive shares of the net income of the partnership derived from sources within and sources without the United States. Such distributive share is included by the individual member as an item of gross income on his individual income tax return. Non-resident alien members are taxable only in respect of their distributive share of income from United States sources, and they include such income as an item of gross income on their tax returns.

The term “domestic partnership”, however, is used in the regulations, meaning a partnership organised or created in or under the law of the United States or of any State or territory—for example, a partnership created by articles entered into in San Francisco between residents of the United States and residents of China. A foreign partnership is one which is not domestic (Art. 1319).

A partnership engaged in trade or business within the United States or having an office or place of business therein is referred to in the income tax regulations as a resident partnership, and a partnership not engaged in trade or business within the United States and not having any office or place of business therein, as a non-resident partnership. Whether a partnership is to be regarded as resident or non-resident is not determined by the nationality or residence of its members or by the place in which it was created or organised.

In determining the liability to tax of the members of a partnership with respect to their distributive shares of the net income of the partnership, it makes no difference whether the partnership is foreign, domestic, resident or non-resident.

Corporations.

A domestic corporation (*i.e.*, one organised in or under the law of the United States or of any State or territory) which has investments or carries on business abroad is taxable on its total income from such foreign as well as domestic sources. This is true even though its sources of income are all situated abroad and even if its real centre of management is abroad.

A foreign corporation (*i.e.*, a corporation organised in or under the laws of another country) is liable only in respect of its income from United States sources (Sec. 231 (a)), regardless of where its real centre of management is situated.

A domestic corporation is a resident corporation, even though it does no business and owns no property in the United States. The regulations employ the term “resident foreign corporation” to describe a foreign corporation which is engaged in trade or business in the United States or has an office or place of business therein, and the term “non-resident foreign corporation” to describe one which is not engaged in trade or business within the United States and does not have any office or place of business therein (Art. 1319).

2. EXEMPTED INCOME.

Numerous items which are exempt from income taxation, and are therefore not to be included in the gross income of any taxpayer, are listed in Section 22(b). Consequently, a citizen, resident or non-resident alien individual, and a domestic or foreign corporation need not include in their gross income, for the purpose of Federal income tax, such items and notably the following, whether or not they are from sources within the United States:

(1) *Life Insurance.* — Amounts received under a life insurance contract paid by reason of the death of the insured, whether in a single sum or in instalments.

(2) *Annuities, etc.* — Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts) under a life insurance, endowment, or annuity contract.

(3) *Gifts, Bequests, and Devises.* — The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income).

(4) *Tax-free Interest.* — Interest upon (a) the obligations of a State, territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act, or under the provisions of such Act as amended; or (c) the obligations of the United States or its possessions. In the case of obligations of the United States issued after September 1st, 1917 (other than postal savings certificates of deposit), the interest shall be exempt only if and to the extent provided in the respective Acts authorising the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income taxes.

(By virtue of Section 4 of the Victory Liberty Loan Act of March 3rd, 1919, amending Section 3 of the Fourth Liberty Bond Act of July 9th, 1918, the interest received on and after March 3rd, 1919, on bonds, notes and certificates of indebtedness of the United States, while beneficially owned by a non-resident alien individual, or a foreign corporation, partnership, or association, not engaged in business in the United States, is exempt from income taxes (Art. 90).)

(See Art. 87 for exemption for citizens or residents from surtax on interest on Liberty bonds, etc.)

3. TAXABLE INCOME.

The tax is upon net income, meaning gross income less statutory deductions. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and deductions, the lines of commercial usage. Subject to these modifications, statutory net income is commercial net income and is to be computed ordinarily in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. The net income of corporations is determined in general in the same manner as the net income of individuals, but the deductions allowed corporations are not precisely the same as those allowed individuals (Sec. 21, Art. 41).

The net income from an estate or from any kind of property held in trust (Secs. 143, 161-170; Arts. 741-746, 861-864, 871, 881, 891), and the net income of a partnership is computed, with certain minor exceptions, in the same manner and on the same basis as the net income of an individual (Secs. 181-189; Arts. 901-903, 911, 921, 931, 941-942).

Allowable Deductions.

The statutory deductions are, in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income (Secs. 23 and 24; Arts. 121-284).

Where it is necessary to segregate United States income from foreign income, as in the case of a non-resident alien or foreign corporation, there are deducted from the items of gross income, determined as being from sources within or without the United States, the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of the deductions which cannot definitely be allocated to some item or class of gross income (Sec. 119 (b) and (d)).

The important deductions follow, those pertaining exclusively to individuals or to corporations being indicated as such :

(a) *Expenses.* — All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance of salaries or other compensation for personal services actually rendered, travelling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business ; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(b) *Interest.* — All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24th, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation.

(c) *Taxes generally.* — Taxes paid or accrued within the taxable year, except :

(1) Income, war profits, and excess profits taxes imposed by the authority of the United States ;

(2) So much of the income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit against the tax under Section 131 ; and

(3) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed ; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

For the purpose of this subsection, estate, inheritance, legacy and succession taxes accrue on the due date thereof, except as otherwise provided by the law of the jurisdiction imposing such taxes, and shall be allowed as a deduction only to the estate.

(d) *Taxes of Shareholder paid by Corporation.* — The deduction for taxes allowed by subsection (c) shall be allowed to a corporation in the case of taxes imposed upon a shareholder of the corporation upon his interest as shareholder which are paid by the corporation without reimbursement from the shareholder, but in such cases no deduction shall be allowed the shareholder for the amount of such taxes.

(e) *Losses by Individuals.* — In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise :

(1) If incurred in trade or business ; or

(2) If incurred in any transaction entered into for a profit, though not connected with the trade or business ; or

(3) Of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck or other casualty or from theft.

In the case of a non-resident alien individual, instead of the losses referred to in (2) and (3) above, the following losses are allowed.

(2) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, shall be allowed whether or not connected with

income from sources within the United States, but only if the profits, if such transaction had resulted in a profit, would be taxable under this title (Sec. 213(b) (1)).

(3) The deduction for losses of property not connected with the trade or business if arising from certain casualties or theft shall be allowed whether or not connected with income from sources within the United States, but only if the loss is of property within the United States (Sec. 213(b) (2)).

(f) *Losses by Corporations.* — In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise, but in the case of a foreign corporation only if and to the extent that they are connected with income from sources within the United States (Secs. 23(f) and 232).

(g) *Bad Debts.* — Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts) ; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part.

(h) *Depreciation.* — A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

(i) *Depletion.* — In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case ; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary.

(j) *Charitable and Other Contributions.* — In the case of an individual, certain contributions or gifts made within the taxable year to or for the use of, notably, any corporation or trust, or community chest, fund, or foundation, organised and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

The total of the deductions taken under the head of charitable and other contributions may not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this deduction. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary. (For unlimited deduction if contributions and gifts exceed 90 per centum of the net income, see Section 120.)

In the case of a non-resident alien individual the so-called "charitable contribution" deduction referred to above shall be allowed whether or not connected with income from sources within the United States, but only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations created in the United States, or to the vocational rehabilitation fund.

(k) *Dividends received by Corporations.* — In the case of a corporation, the amount received as dividends :

(1) From a domestic corporation (other than a corporation organised under the China Trade Act, 1922), or

(2) From any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per cent of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under Section 119 (Secs. 23(p) and 233).

(1) In the case of any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) or has entered into a contract or option to acquire substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, no deduction for the loss is allowed under Section 23(e) (2) or Section 23(f) unless the claim is made by a corporation, a dealer in stocks or securities, and with respect to a transaction made in the ordinary course of its business. If such acquisition or contract or option to acquire is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed (Sec. 118).

Credits against Net Income.

After determining the amount of taxable net income, an adjustment must be made before proceeding to the calculation of the amount of tax due on such income. This adjustment relates to what are known as credits. A credit is a sum which is to be subtracted from net income before calculating the normal tax (but not surtax) of non-corporate taxpayers and the entire income tax of corporations.

The credits for individuals include the personal exemption, credit for dependents, dividends received from a domestic corporation, or from a foreign corporation deriving more than 50 per cent of its gross income for the preceding three years from United States sources, and interest on United States obligations (Sec. 25 ; Arts. 291-295).

In computing the tax on corporations, certain credits are allowed against net income, including interest upon United States obligations, and, in the case where a domestic corporation has a net income of \$25,000 or less, a specific credit of \$3,000 (Secs. 13 and 26 ; Arts. 31 and 301).

4. CALCULATION OF THE TAX.

After reduction of the net income of individuals by the personal exemption, the credit for dependants, the credit for interest on certain United States obligations and for dividends, the normal tax is calculated. The total tax of non-corporate taxpayers consists of the normal tax and surtax. The surtax is levied upon the net income without allowance of any credits against net income.

A corporation pays the special corporation tax and is not liable to surtax.

Credits against Tax.

The tax may be reduced by subtracting therefrom certain credits for earned income (in the case of individuals only) (Sec. 31, Arts. 311, 312) ; in the case of citizens, resident aliens, and domestic corporations, for income taxes paid to foreign countries or possessions of the United States ; and, for tax paid at the source, in the case of any taxpayer in whose behalf such tax has been paid (Secs. 131 and 144(d)).

PART II. — METHODS OF TAXING FOREIGN AND NATIONAL ENTERPRISES.

A. FOREIGN ENTERPRISES.

It is assumed that the term "foreign enterprise" means a business or an undertaking in the United States by (a) a non-resident alien individual; (b) a partnership composed of non-resident alien individuals, or (c) a foreign corporation.

I. GENERAL PRINCIPLES.

The general rule is that a non-resident alien individual, whether operating alone or in a partnership, or of a foreign corporation, extending its enterprise into the United States, is taxable in respect of income from sources within the United States (Secs. 212(a), 231(a)). Such taxpayers are permitted to deduct from their gross income the deductions allowable under Section 23, but only if and to the extent that such deductions are connected with income from sources within the United States (Secs. 213 and 232).

In Section 119 are mentioned items of income which are to be treated as income from sources within the United States, such as interest, dividends, rents, royalties and gains derived from the sale of real and personal property. These specific items will be discussed in detail below. In general, it may be stated that a non-resident alien individual or a foreign corporation is taxable with respect to any gain, profit or income provided it is derived from sources within the United States, and it is not specifically exempt from tax by statute or fundamental law.

The following paragraphs will first describe the application of the United States tax to certain kinds of income, in order to show how the recipient would be taxed in case it derived income from only one of the indicated sources. Inasmuch as the tax in the case of a foreign enterprise is always on total net income from United States sources, the procedure in assessment and collection applicable to the various items which are included in the declaration of the taxpayer will then be discussed in detail.

II. TAXATION OF CERTAIN ITEMS OF INCOME.

(a) *Dividends.*

A non-resident alien individual or a foreign corporation, whether or not having within the country an office or place of business at which the income is received, must include in gross income the amount received as dividends:

(i) From a domestic corporation other than a corporation entitled to the benefits of Section 251 (defined below) and other than a corporation less than 20 per centum of whose gross income is shown to the satisfaction of the Commissioner to have been derived from sources within the United States, as determined under the provisions of Section 119, for the three-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence); or

(ii) From a foreign corporation where 50 per cent or more of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of Section 119 (Sec. 119 (a) (2)).

A domestic corporation entitled to the benefits of Section 251 is one which derives 80 per cent or more of its gross income from a possession of the United States (such as Porto Rico, Philippine Islands, etc.), 50 per cent of which is derived from the active conduct of a trade or business within a possession of the United States (Sec. 251(a)).

The non-resident alien individual pays only surtax on such dividends because of the credit for such dividends against net income. A foreign corporation pays no tax on such dividends, because it may deduct them in computing taxable net income.

(b) *Interest.*

A non-resident alien individual or a foreign corporation must include in gross income interest on bonds, notes or other interest-bearing obligations of residents in the United States, corporate or otherwise, not including:

(i) Interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein; or

(ii) Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that less than 20 per cent of the gross income of such resident payer or domestic corporation has been derived from sources within the United States, as determined under the provisions of Section 119, for the three-year period ending with the close of the taxable year of such payer preceding the payment of such interest, or for such part of such period as may be applicable; or

(iii) Income derived by a foreign central bank of issue from bankers' acceptances (Sec. 119(a) (1)).

A foreign corporation which engages in buying, without selling, in the United States is engaged in business within the United States, and therefore the interest on its bank deposit in the United States is subject to income tax (I.T. 1306, C.B. 1-2, page 151).

Income derived by non-resident foreign corporations from purchasing acceptances of banks in the United States at a discount and holding them until maturity is taxable as income from sources within the United States, regardless of where payment is made at maturity, under Section 217 of the Revenue Act of 1926 (I.T. 2330, C.B. VI-1, page 76).

Interest from the above-indicated sources is subject to both normal tax and surtax when derived by non-resident alien individuals, and to corporation tax when derived by corporations. The normal tax on non-resident alien individuals and the corporation tax on non-resident foreign corporations are subject to withholding at the source, the rates depending upon whether there is a tax-free covenant and the terms thereof as is described below under the heading "Income subject to withholding". Resident foreign corporations pay tax on this income on the basis of their return in the same manner as domestic corporations.

Discounts are not subject to withholding, but are included in the taxpayer's return of income from United States sources.

(c and d) *Patents, Copyright and Mining Royalties and Rents from Real Estate.*

Non-resident aliens and foreign corporations must include in gross income rentals or royalties from property located within the United States or from any interest in such property, including rentals or royalties for the use of, or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises and other like property (Sec. 119(a) (4)).

Royalties paid to a non-resident foreign corporation are income from sources within the United States when paid for the use in the United States of property belonging to such corporation (I.T. 2039, C.B. III-1, page 226).

Non-resident aliens are liable to both normal tax and surtax, and foreign corporations to the corporation tax, in respect of this kind of income. In the case of rents, royalties and other fixed or determinable annual or periodical gains, profits and income in this category, the normal tax is withheld from amounts paid to non-resident aliens and the corporation tax from amounts paid to foreign corporations. The non-resident alien pays any surtax due on such income on the basis of his return.

(e) *Gain derived from the Sale of Real Estate and Securities.*

The gain derived from the sale of real estate located in the United States is taxable. The entire gain derived from the sale of securities is gross income from sources within the United States if the sale takes place in the United States, regardless of whether the purchase took place in the United States or abroad. Correspondingly, no liability arises when securities or goods are purchased in the United States but sold abroad. The fact that the sale may be an isolated transaction and not connected with the taxpayer's trade or business is immaterial (Sec. 119(a) (5) and (e)).

Such income is not subject to tax by withholding, but is payable on the basis of the taxpayer's return. It is subject to normal tax and surtax when derived by a non-resident alien and to the corporation tax when derived by a foreign corporation.

The constitutionality of the taxation of gains derived from the sale of capital assets and also the gain derived from an isolated transaction has been decided by the Supreme Court of the United States in *Merchants Loan and Trust Company v. Smietanka* (255 U.S. 509), and *Eldorado Coal and Mining Company v. Mager* (255 U.S. 522). These decisions are published as T.D. 3173 and T.D. 3175, respectively, appearing on pages 34 and 38, respectively, *Cumulative Bulletin*, No. 4, January to June 1921.

For determining the place of sale in deciding the source of income, the substance of the sale is the agreement to sell. Therefore, if the contract to sell is concluded in the United States, the profit arising from the sale is taxable (see G.C.M. No. 8594, appearing on page 3 of *Internal Revenue Bulletin*, Volume IX, No. 44, which is based upon the decision of the Supreme Court of the United States in *Compania General de Tabacos de Filipinas v. Collector* (279 U.S. 306)).

(f) *Salaries, Wages, etc.*

Gross income from sources within the United States includes compensation (salaries, wages, commissions, etc.) for labour or personal services performed within the United States regardless of the residence of the payer, of the place in which the contract for services was made, or of the place of payment. When a specific amount is paid for labour or personal services performed in the United States, such amount shall be included in the gross income. When no accurate allocation or segregation of compensation for labour or personal services performed in the United States can be made, or when such labour or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis—*i.e.*, there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labour or services within the United States bears to the total number of days of performance of labour or services for which the payment is made. The wages of an alien seaman earned on a coastwise vessel are from sources within the United States (see Art. 674).

The normal tax is subject to withholding by the employers, but the surtax is payable by the non-resident alien on the basis of a return.

A few examples of cases where the compensation of non-resident aliens has been taxed are given below.

Certain employees of a foreign corporation are non-resident aliens. Therefore, they are taxable upon their compensation received for services rendered in the United States where they are despatched temporarily to a United States office maintained as headquarters for such employees, who study railway conditions in this country (I.T. 2018, C.V. : III-1, page 209).

A non-resident alien individual who received compensation for services performed on vessels operating between Canada and the United States is held to be in receipt of compensation for services performed partly within and partly without the United States, regardless of the fact that the vessel is under Canadian registry. In view of the fact that the vessel on which the individual is employed is a ferry-boat making regular trips between a port in the United States and a port in Canada, one-half of such service is performed within the United States and one-half within Canada. One-half of the compensation received is, therefore, compensation for services performed within the United States, which is subject to Federal income taxation and subject to the withholding provisions of the 1921 Act (I.T. 1449, C.B. 1-2, page 152).

(g) *Income derived from Trusts in the United States.*

The distributable income of a trust in the United States, which is distributable to non-resident alien individuals, is taxable income provided the items of such trust income are from sources within the United States.

Where interest and dividends have been received by a domestic trust from sources outside the United States and the income of the trust is to be distributed annually, the distributee's share of such interest and dividends paid to a non-resident alien beneficiary should not be reported by such beneficiary to the United States for income tax purposes (I.T. 1642, C.B. II-1, page 81).

Where a citizen or resident fiduciary has the distribution of the income of a trust any beneficiary of which is a non-resident alien, the fiduciary shall make a return on Form 1040B for such non-resident alien and, unless the beneficiary has designated an agent for that purpose, its fiduciary pays any tax shown thereon to be due.

(h) *Income from the carrying on of a Trade or Business.*

It is the deriving of income from sources within the United States that entails liability for a non-resident alien or foreign corporation, and not the fact of "carrying on a trade or business" in the United States, as the latter concept does not exist in the Revenue Act of 1928. Thus, if a foreign enterprise is engaged in the purchase, or manufacture, of goods abroad and their sale in the United States, it is the fact of sale in the United States that gives rise to liability. If goods are purchased in the United States and sold abroad, no liability arises even though such is the regular business of the foreign enterprise (Sec. 119(c)).

According to General Counsel Memorandum 8594 (*Internal Revenue Bulletin*, Vol. IX, No. 44, page 3), the sale takes place where the contract is concluded. Consequently, the conclusion of the sales contract in the United States determines liability when business is transacted through (1) a commission agent or broker, (2) a travelling salesman, (3) an agent with a power of attorney, (4) an agent selling out of a stock owned by the foreign enterprise, or (5) a permanent establishment of any kind. If the deal were closed abroad, under the cited ruling, the profit would not be treated as income from United States sources.

Considering the normal functions of a commission agent or broker, or of a travelling salesman, it is obvious no liability to tax is likely to arise, subject always to the proviso that it will arise if they should conclude the contract. Liability is likely to be incurred, however, because of the very character of (3) an agent with a power of attorney, (4) an agent selling out of a stock owned by the foreign enterprise, and (5) a permanent establishment of any kind.

A foreign enterprise is taxable when it produces or manufactures goods in the United States through an authorised agent of some kind or a permanent establishment and sells them abroad, or renders transportation or other services between points in the United States and points in foreign countries. There is an exemption granted, however, for the shipping profits of foreign enterprises provided the country to which they belong grants a similar exemption to American enterprises (Secs. 212(b) and 231 (b)).

The income from the operation within the United States of public utilities, such as the furnishing of gas, light, power, water, coal, telephone service, etc., is income from sources within the United States.

Whatever may be the nature of the operations carried on in the United States, the income derived by a non-resident alien is subject to normal tax and surtax and that derived by a foreign corporation to the corporation tax, the assessment being made on the basis of a return.

III. TAXATION OF TOTAL INCOME FROM UNITED STATES SOURCES.

I. COMPUTATION OF TAXABLE INCOME.

As the American tax is upon the net income which a foreign enterprise derives from any or all of the above-indicated sources, from the gross income ascertained as being from such sources within the United States, there should be deducted the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, constitutes net income from sources within the United States (Sec. 119(b)).

The manner of allocating items of gross income and deductions as between the United States and the other countries in which an enterprise operates is fully described in Part III.

Credits against Net Income.

A non-resident alien individual is permitted to deduct from his total net income, for the purpose of computing the normal tax but not the surtax, the following credits :

(a) The amount received as dividends from a domestic corporation (other than a corporation organised under the China Trade Act, 1922) ; or

(b) From a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per cent of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of Section 119 ;

(c) A credit for personal exemption amounting to \$1,500, regardless of his marital status ; and

(d) Only in the case of aliens who are residents of a contiguous country, a credit of \$400 for each person (other than husband and wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under 18 years of age, or is incapable of self-support because mentally or physically defective.

A foreign corporation is not allowed any specific credit against its net income.

2. COMPUTATION OF TAX.

(a) The general rule is that, in the case of a non-resident alien individual who is not a resident of a contiguous country (Canada or Mexico), the normal tax shall be :

5 per cent of the amount of the net income in excess of the credits against net income allowed to such individual (Sec. 211(a)).

(b) In the case of an alien individual resident in a contiguous country (Canada or Mexico), the normal tax shall be an amount equal to the sum of the following :

(1) 1½ per cent of the amount by which the part of the net income attributable to wages, salaries, professional fees, or other amounts received as compensation for personal services actually performed in the United States exceeds the personal exemption and credit for dependents ; but the amount taxable at such 1½ per cent rate shall not exceed \$4,000 ;

(2) 3 per cent of the amount by which such part of the net income exceeds the sum of (A) the personal exemption and credit for dependents, plus (B) \$4,000 ; but the amount taxable at such 3 per cent rate shall not exceed \$4,000 ; and

(3) 5 per cent of the amount of the net income in excess of the sum of (A) the amount taxed under paragraphs (1) and (2) of this subsection, plus (B) the total credits against net income allowed to such individual (Sec. 211(b)),

In addition, the net income of a non-resident alien individual is subject to graduated surtaxes ranging from 1 per cent on net incomes in excess of \$10,000 to 20 per cent on net incomes in excess of \$100,000 (Sec. 12(a)).

The following table shows the surtax due for 1928 and subsequent years upon certain specified amounts of net income. In each instance the first figure of the net income in the net income column is to be excluded and the second figure included. The percentage given opposite applies to the excess of income over the first figure in the net income column. The last column gives the total surtax on a net income equal to the second figure in the net income column (Art. 22).

Net income \$	Per cent	Total surtax \$
0 to 10,000		
10,000 to 14,000	1	40
14,000 to 16,000	2	80
16,000 to 18,000	3	140
18,000 to 20,000	4	220
20,000 to 22,000	5	320
22,000 to 24,000	6	440
24,000 to 28,000	7	720
28,000 to 32,000	8	1,040
32,000 to 36,000	9	1,400
36,000 to 40,000	10	1,800
40,000 to 44,000	11	2,240
44,000 to 48,000	12	2,720
48,000 to 52,000	13	3,240
52,000 to 56,000	14	3,800
56,000 to 60,000	15	4,400
60,000 to 64,000	16	5,040
64,000 to 70,000	17	6,060
70,000 to 80,000	18	7,860
80,000 to 100,000	19	11,660
100,000 up	20	

The surtax for any amount of net income not shown in the table is computed by adding to the surtax for the largest amount shown which is less than the income the surtax upon the excess over that amount at the rate indicated in the table. Accordingly, the surtax upon a net income of \$63,128 should be \$4,900.48, computed as follows :

	\$
Surtax on \$60,000 from table	4,400.00
Surtax on \$3,128 at 16 per cent.	<u>500.48</u>
Total	\$4,900.48

In the case of a bona-fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the surtaxes attributable to such sale shall not exceed 16 per cent of the selling price of such property or interest (Sec. 102(a)).

In lieu of computing the tax on the profits derived from the sale of exchange of capital assets at the normal tax and surtax rates referred to, a non-resident alien individual may, at his option, subject such profits to a flat rate of 12½ per cent. The term "capital assets" for the purpose of this tax means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock-in-trade of the taxpayer or other property of a kind which would properly be included in his inventory if on hand at the close of the taxable year, or property held by him primarily for sale in the course of his trade or business (Sec. 101).

The net income of a foreign corporation is subject to tax at the rate of 12 per cent.

Credits against Tax.

A non-resident alien individual is entitled to deduct from the tax computed on his individual income tax return, Form 1040B, the following credits :

- (1) Earned income credit, and
- (2) Credit for tax paid at source.

A foreign corporation is not entitled to any credit against its net income.

Earned Income Credit.

For the purpose of computing this credit, "earned income" means wages, salaries, professional fees and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer, not in excess of 20 per cent of his share of the net profits of such trade or business, shall be considered as earned income.

"Earned income deductions" means such deductions as are allowed by Section 23 for the purpose of computing net income, and are properly allocable to or chargeable against earned income.

“Earned net income” means the excess of the amount of the earned income over the sum of the earned income deductions. If the taxpayer’s net income is not more than \$5,000, his entire net income shall be considered to be earned net income, and, if his net income is more than \$5,000, his earned net income shall not be considered to be less than \$5,000. In no case shall the earned net income be considered to be more than \$30,000.

In the case of an individual, the tax shall be credited with 25 per cent of the amount of tax which would be payable if his earned net income constituted his entire net income; but in no case shall the earned income credit allowed exceed 25 per cent of his normal tax plus 25 per cent of the surtax which would be payable if his earned net income constituted his entire net income (Sec. 31).

The following are examples of computing the credits for earned income and for tax paid at source in the case of a non-resident alien individual:

1. A non-resident alien individual (not a resident of Canada or Mexico) came to the United States in September 1930 for the purpose of conducting concerts in New York, New York, for which he was paid \$35,000. This amount constituted his total income from all sources within the United States during the entire year 1930. He had no allowable deductions from his gross income. The alien filed an exemption certificate, Form 1115, claiming the benefit of the personal exemption of \$1,500, with the payer of the salary, who deducted a tax of 5 per cent from the excess over \$1,500 (\$33,500), the tax amounting to \$1,675.

Aliens departing from the United States are required to satisfy all income tax obligations before they leave the country (Sec. 147(e) and Art. 801).

On January 5th, 1931, the day before the alien departed from the United States, he presented himself at the office of the internal revenue agent in charge in New York, New York, and, in accordance with Article 801, made a declaration of his entire income from all sources within the United States for the year 1930 and submitted evidence to the effect that \$1,675 had been withheld at the source from such income. The examining officer computed his tax on Form 1040C in the following manner:

Total net income		\$35,000
Less: Personal exemption		<u>1,500</u>
Balance		\$33,500
Normal tax at the rate of 5 per cent		\$1,675
Surtax on \$35,000		<u>1,310</u>
Total tax		\$2,985
Earned net income	\$30,000	
Less: Personal exemption	<u>1,500</u>	
Balance	\$28,500	
Normal tax at 5 per cent.	\$1,425	
Surtax on \$30,000	<u>880</u>	
Total tax	\$2,305	
25 per cent of \$2,305		<u>576.25</u>
Less tax paid at the source.		\$2,408.75
		<u>\$1,675</u>
Balance due		\$733.75

2. A non-resident alien individual received interest on bonds containing a tax-free covenant amounting to \$10,000 on which a tax at the rate of 2 per cent, or \$200, was paid by the obligor. The taxpayer paid to the country of which he was a resident a tax of \$500 on such income. This tax is an allowable deduction from his gross income in computing his net income for the purpose of the normal Federal income tax. His tax is computed as follows :

Total net income (\$10,000, less foreign tax of \$500)	\$9,500.00
Less: Personal exemption	<u>1,500.00</u>
Balance	\$8,000.00
Normal tax at 5 per cent.	\$400.00
Earned net income allowance	\$5,000
Less: Personal exemption	<u>1,500</u>
Balance	\$3,500
Normal tax at 5 per cent	\$175
25 per cent of \$175	<u>43.75</u>
	\$356.25
Less tax paid at the source	<u>200.00</u>
Balance of tax due	\$156.25

An alien resident of a contiguous country is required to file an individual return, Form 1040B, in order to obtain the benefit of the earned income credit (I.T. 2144, C.B. IV-1, page 14).

A non-resident alien individual and a non-resident foreign corporation, in computing their Federal income tax on their returns, Form 1040B (individual return) or Form 1120 (corporation return), are entitled to deduct from the tax computed thereon the amount of the tax withheld at the source (Sec. 144(d)).

3. COLLECTION OF THE TAX.

The collection of the tax of a non-resident alien individual or a foreign corporation is effected by two means :

(a) By having the tax (or a portion thereof) withheld at the source by the payer of the income, who in turn pays the withheld tax to the Government. The amount of tax so withheld is credited against the tax on income from United States sources assessed on the basis of a return.

(b) By the taxpayer, or his or its duly authorised agent, filing a return and paying the tax direct to the collectors of internal revenue.

(a) Withholding at Source.

General Provisions regarding withholding.

Withholding of a tax of 5 per cent is required in the case of fixed or determinable, annual or periodical income, including interest, rent, premiums, annuities, royalties and salaries, paid to a non-resident alien or to a non-resident partnership composed in whole or in part of

non-resident alien individuals: except (1) income from sources without the United States including interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having any office or place of business therein; (2) dividends of a class allowed as a credit—namely, dividends from a domestic corporation or a foreign corporation deriving more than 50 per cent of its gross income from United States sources; and (3) interest upon bonds or other obligations of a corporation containing a tax-free covenant.

A tax of 12 per cent is required to be withheld in the case of fixed or determinable annual or periodical income, other than the three exceptions listed in the preceding paragraph, paid to a non-resident foreign corporation.

The income of resident foreign corporations is free from withholding (Secs. 144 and 145; Arts. 761-770, 781).

A tax of 2 per cent must be withheld from interest paid to a non-resident individual, partnership or foreign corporation upon bonds or other obligations of domestic corporations or resident foreign corporations containing a tax-free covenant, except that, if the liability assumed by the obligor in connection with such a covenant does not exceed 2 per cent of the interest, withholding is required at the rate of 5 per cent in the case of a non-resident alien or a non-resident partnership composed in whole or in part of non-resident alien individuals, and at the rate of 12 per cent in the case of a non-resident foreign corporation.

If less than 20 per cent of the gross income of a domestic corporation or a resident foreign corporation has been derived from sources in the United States, then interest payments on the bonds or obligations of such corporations made to a non-resident alien, a partnership composed in whole of non-resident aliens, or a non-resident foreign corporation, are not subject to withholding (Sec. 144; Art. 761).

Income subject to withholding.

Among the items of fixed or determinable, annual or periodical income which are subject to withholding are interest, rent, royalties, salaries, wages, premiums, annuities, compensations, remunerations and emoluments (Sec. 144(b) and Art. 762).

A gain derived from the sale of real or personal property is not fixed or determinable, annual or periodical income, and is therefore not subject to withholding (Art. 762).

Although as heretofore stated partnerships are not taxable entities, certain fixed or determinable, annual or periodical income of partnerships is subject to withholding.

For the purpose of discussing the rates of tax required to be withheld, fixed or determinable, annual or periodical income may be divided into the following classes:

- (1) Interest on corporate obligations containing a tax-free covenant in which the liability assumed by the obligor exceeds 2 per cent of the interest:
- (2) Interest on corporate obligations containing a tax-free covenant in which the liability assumed by the obligor does not exceed 2 per cent of the interest:
- (3) Interest on corporate bonds not containing a tax-free covenant; and
- (4) Other income, such as rent, royalties, salaries, wages, etc.

Tax-free Covenant.

In the case of interest on corporate obligations containing a tax-free covenant (although the law requires withholding at a certain rate), the portion of the tax which the obligor agrees to pay in behalf of its bondholders is not actually withheld from the interest but is paid from

the obligor's own funds. For example, if, under the law, 2 per cent is required to be paid at the source, the bondholder receives his interest in full without any deduction, the 2 per cent being paid from the funds of the obligor. If the law requires 5 per cent to be paid and the obligor has agreed to pay 2 per cent, then 3 per cent of the interest is actually withheld from it, the remaining 2 per cent being paid from the funds of the obligor. This is true also where the obligor has agreed to pay all taxes, but his actual liability is limited to 2 per cent by the law.

For convenient reference, the alternative requirements of Section 144(a) (1) as to the nature of the contract or covenant which the debtor corporation must undertake may be stated as follows :

- (1) To pay any portion of the income tax imposed upon the obligee ; or
- (2) To reimburse the obligee for any portion of the tax ; or
- (3) To pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon or to retain therefrom under any law of the United States.

The requirements of the statute may be met by the employment of the identical language of the statute, but this method of compliance therewith is not exclusive. It is sufficient if the substance of the requirements enumerated in the statute are found in the particular clause under consideration. It is relatively simple to determine whether either of the first two requirements above mentioned are complied with. As to the third, it can only be stated in general terms that this requirement is met if the clause in question either designates a tax which is, in fact, the sort of tax contemplated by the statute or contains a general description of taxes broad enough to include a tax such as mentioned in the statute, although it may include others also.

Liability assumed by Obligor. — The following is an example of a tax-free covenant in which the liability assumed by the obligor exceeds 2 per cent :

“Both the principal and interest of this bond are payable without deduction, defalcation, or abatement to be made of anything for or in respect of any taxes, charges or assessments whatsoever.”

The following is an example of a tax-free covenant in which the liability assumed by the obligor does not exceed 2 per cent :

“All payments upon this bond, both of principal and interest, shall be made without deducting any Federal income tax (not exceeding the present rate of 2 per cent per annum upon said interest) imposed by any present or future law of the United States which the corporation may be required to pay, deduct or retain from said interest payments” (I.T. Mimeograph 3659, C.B. VII-2, page 66).

Rates of Withholding.

The following income of non-resident alien individuals, either received directly or through a partnership, and non-resident foreign corporations is subject to withholding at the following rates :

Taxpayer	Character of income	Rate of tax actually withheld Per cent	Rate of tax paid to the Government Per cent
Non-resident alien individual ¹	Interest on corporate bonds containing a tax-free covenant in which the liability assumed by the obligor exceeds 2 per cent	0	2
A partnership not engaged in trade or business within the United States and not having office or place of business therein, composed in whole or in part of non-resident aliens ¹	Interest on corporate bonds containing a tax-free covenant in which the liability assumed by the obligor exceeds 2 per cent	0	2
A foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein ¹	Interest on corporate bonds containing a tax-free covenant in which the liability assumed by the obligor exceeds 2 per cent	0	2
Non-resident alien individual	Interest on corporate bonds containing a tax-free covenant in which the liability assumed by the obligor does not exceed 2 per cent	3	5
A partnership not engaged in trade or business within the United States not having any office or place of business therein, composed in whole or in part of non-resident aliens	Interest on corporate bonds containing a tax-free covenant in which the liability assumed by the obligor does not exceed 2 per cent	3	5

¹ In the first three cases, the balance of the normal tax, 3 per cent, or corporation tax, 10 per cent, is paid by the taxpayer on the basis of his return.

Taxpayer	Character of income	Rate of tax actually withheld Per cent	Rate of tax paid to the Government Per cent
A foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein	Interest on corporate bonds containing a tax-free covenant in which the liability assumed by the obligor does not exceed 2 per cent	10	12
Non-resident alien individual	Interest on corporate bonds not containing a tax-free covenant	5	5
A partnership not engaged in trade or business within the United States not having any office or place of business therein, composed in whole or in part of non-resident aliens	Interest on corporate bonds not containing a tax-free covenant	5	5
A foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein	Interest on corporate bonds not containing a tax-free covenant	12	12
Non-resident alien individual	Other fixed or determinable, annual or periodical income such as interest, rent, salaries, royalties, etc.	5	5
A partnership not engaged in trade or business within the United States not having any office or place of business therein, composed in whole or in part of non-resident aliens	Other fixed or determinable, annual or periodical income, such as interest, rent, salaries, royalties, etc.	5	5
A foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein	Other fixed or determinable, annual or periodical income, such as interest, rent, salaries, royalties, etc.	12	12

Ownership Certificates for Bond Interest.

Non-resident alien individuals, partnerships and foreign corporations (and all other taxpayers except domestic and resident foreign corporations), owners of bonds or other obligations containing a tax-free covenant, issued by a domestic corporation or a resident foreign corporation, when presenting interest coupons for payment, shall file an ownership certificate for each issue of bonds, showing the name and address of the debtor corporation, the name and address of the owner of the bonds, a description of the obligations, the amount of interest and its due date, the rate at which tax is to be withheld, and the date upon which the interest coupons were presented for payment.

Ownership certificates need not be filed, however, by a non-resident alien, a partnership composed in whole of non-resident aliens, or a non-resident foreign corporation in connection with interest payments on such bonds or similar obligations of a domestic or resident foreign corporation deriving less than 20 per cent of its gross income from sources within the United States, or of a non-resident foreign corporation (Art. 765).

In the case of interest on corporate bonds or similar obligations not containing a tax-free covenant, issued by a domestic or resident foreign corporation deriving 20 per cent or more of its gross income from United States sources, ownership certificates are required if the owner of such bonds is a non-resident alien, a non-resident partnership composed in whole or in part of non-resident aliens, or a non-resident foreign corporation (Art. 765).

Credits claimed at Source.

The tax is withheld from the gross amount of the income, and no deductions or credits to which a non-resident alien individual or a foreign corporation may be entitled can be claimed unless the taxpayer files a true and accurate return of net income from all sources within the United States, except in the case of:

- (1) A non-resident alien individual receiving compensation for services rendered in the United States; or
- (2) A non-resident alien individual receiving interest on corporate bonds.

A taxpayer receiving compensation for services rendered in the United States may claim the benefit of the personal exemption of \$1,500 and, if he is a resident of Canada or Mexico, the \$400 credit for dependents and the lower rates of tax applicable to such compensation as provided by Section 211(b), by filing with his employer an exemption certificate, Form 1115 (Art. 1072).

Exemption Certificates of Non-Resident Aliens.

When the gross income of a non-resident alien, which is derived from sources within the United States, does not exceed \$10,000 and, exclusive of dividends, is not in excess of the personal exemption of \$1,500 (and the credit for dependents in the case of a resident of Canada or Mexico), an exemption certificate, Form 1002, may be executed and filed with the withholding agent, if any part of such gross income is derived from interest upon bonds or similar obligations of a corporation, whether or not such bonds or obligations contain a tax-free covenant (Art. 764).

Any other deductions or credits to which a non-resident alien individual is entitled may only be claimed on an individual income tax return, Form 1040B, which is required to be filed by the individual or his responsible representative in the United States, unless the tax on such income has been fully paid at the source (Sec. 215 and Art. 1081).

A return of income from all sources within the United States is required to be filed by a non-resident foreign corporation on Form 1120; but, if the corporation has an agent in the United States, the return is filed by the agent (Secs. 52(a) and 235).

(b) *Return and Payment of Tax.*

Non-resident Aliens. — A non-resident alien individual must make, or cause to be made, a return and pay tax on or before June 15th following the close of the calendar year, or on or before the 15th day of the sixth month following the close of his fiscal year, to the collector of internal revenue at Baltimore, Maryland. Such individual makes, or has made, a full and accurate return on Form 1040B of his gross income received from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source.

The responsible representatives or agents of non-resident aliens in connection with any sources of income which such non-resident aliens may have within the United States must make a return of the income from such sources, and pay any normal tax or surtax assessed upon income received by them in behalf of their non-resident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source.

The agency appointment will determine how completely the agent is substituted for the principal for tax purposes. A bank or trust company which collects interest or dividends on deposited securities of a non-resident alien, executes ownership certificates in connection therewith, and sells such securities under special instructions is not deemed merely by such acts to be the responsible representative or agent of the non-resident alien.

Such bank or trust company is not required to make a return of the income received by it in connection with such deposited securities or to pay any tax thereon, except in cases where the amount of such income is \$1,500 or over, unless specially appointed for that purpose or unless by reason of other facts it has become such responsible representative or agent.

Where upon filing a return of income it appears that a non-resident alien is not liable for tax, but nevertheless a tax shall have been withheld at the source, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents (Secs. 217-218; Arts. 1081, 1091).

Non-Resident Aliens with Income from an Estate or Trust. — Where a citizen or resident fiduciary has the distribution of the income of a trust any beneficiary of which is a non-resident alien, the fiduciary shall make, on or before the 15th day of the third month following the close of the fiscal or calendar year, a return on Form 1040B for such non-resident alien and pay any tax shown to be due thereon.

Unless such return is a true and accurate return of the non-resident alien beneficiary's income from all sources within the United States, the benefits of the credits and deductions to which the beneficiary is entitled cannot be obtained in the return filed by the fiduciary (Sec. 215).

If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns, the fiduciary shall be relieved from the necessity of filing Form 1040B in behalf of the beneficiary and from paying the tax. In such a case, the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment.

If the sole beneficiary of an estate or trust is a non-resident alien and Form 1040B is filed by the fiduciary, the filing of Form 1041 will not be required. If there are two or more non-resident alien beneficiaries, the fiduciary shall render a return on Form 1041 and also a return on Form 1040B for each non-resident alien beneficiary (Sec. 143; Art. 745).

Partnerships. — A partnership must make, on or before the 15th day of the third month following the close of the fiscal or calendar year, a return of income, regardless of the

amount of its net income, on Form 1065, which must be sworn to by one of the partners. The return is made for the annual accounting period (fiscal year or calendar year) of the partnership, irrespective of the taxable years of the partners (Sec. 189; Arts. 901, 941-942).

The return states, not only the items of gross income and the allowable deductions, but also the name and address and distributive share of each partner. Each partner is required to include his distributive share in his own return, and is taxed in accordance with his status, whether a citizen, resident alien or non-resident alien.

Foreign partnerships, regardless of whether or not they maintain an office or place of business in the United States, are given an extension of time for filing returns of income up to and including the 15th day of the sixth month following the close of the taxable year, but must attach an affidavit to the return stating the cause of the delay in filing (Sec. 53; Arts. 401-404).

Corporations. — The return filed by a corporation subject to tax must state specifically the items of gross income and allowable deductions and credits, and be sworn to by the president, vice-president, or other principal officer or by the treasurer or assistant treasurer (Sec. 52; Art. 391).

A foreign corporation receives the benefit of deductions and credits allowed to it only by filing a true and accurate return of its total income received from all sources within the United States including therein all the information which the Commissioner may deem necessary for calculations of such deductions and credits (Sec. 233).

While the normal time for filing corporate returns and paying tax is the 15th day of the third month following the close of the fiscal or calendar year, foreign corporations which maintain an office or place of business in the United States are granted an extension of time for filing returns up to and including the 15th day of the sixth month following the close of the taxable year, provided an affidavit is attached to the return stating the cause of the delay in filing (Art. 403).

A foreign corporation which does not have an office or place of business in the United States is not required to file its return and pay tax until on or before the 15th day of the sixth month following the close of its fiscal year or the calendar year. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return must be made by the agent (Sec. 235).

No tax is required to be paid by any foreign corporation until the 15th day of the sixth month following the close of its taxable year (June 15th if on the calendar year basis (Sec. 236)).

A corporation makes returns and pays tax to the collector of the district in which is located its principal place of business or principal office or agency, or if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland (Sec. 53(b) (2)).

Payment in Instalments.

At the option of the taxpayer, the tax may be paid in four equal instalments instead of in a single payment, in which case the first instalment is to be paid on or before the date prescribed for the payment of the tax as a single payment, the second instalment on or before the 15th day of the third month, the third instalment on or before the 15th day of the sixth month, and the fourth instalment on or before the 15th day of the ninth month, after such date.

When the taxpayer elects to pay the tax in four instalments, each of the four instalments must be equal in amount, but any instalment may be paid, at the election of the taxpayer, prior to the date prescribed for its payment. If an instalment is not paid in full on or before the date fixed for its payment either by the Act or by the Commissioner of Internal Revenue in accordance with the terms of an extension, the whole amount of the tax unpaid shall be paid upon notice and demand from the collector (Sec. 56(b); Art. 431).

Extension of Time for Payment.

On showing that hardship would otherwise result, a taxpayer may apply for an extension of the time for payment of the whole amount of his tax, or any part or instalment thereof, for a period not to exceed six months from the date prescribed for the payment of such amount, part or instalment.

The application is made to the Commissioner of Internal Revenue through the collector of internal revenue for the district in which the taxpayer's return was filed (Sec. 56(c) ; Art. 432).

Receipts for Tax Payments.

If requested, a collector will give a receipt for each tax payment. The cancelled cheque or the money order receipt is considered a sufficient receipt where payments are made by cheque or money order.

Whenever a debtor pays taxes on account of payments made by him to separate creditors, he may obtain from the collector a separate receipt for the tax paid on account of each creditor (Sec. 56(h) ; Art. 434).

Tax withheld: Return and Payment.

Every person required to deduct and withhold tax is required to make a return thereof on or before March 15th of each year following that in which the tax is withheld and to pay the tax on or before June 15th.

Income thus taxed at source must be included in the return of the recipient of such income, but the amount of tax withheld is credited against the amount of income tax as computed in such return (Sec. 144(c) and (d) ; Art. 768).

B. DOMESTIC ENTERPRISES.

It is assumed that the term "national enterprise" means a business or undertaking in a foreign country by :

- (a) A citizen of the United States or a resident of the United States ;
- (b) A partnership composed either in whole or in part of citizens of the United States or residents of the United States ; or
- (c) A domestic corporation.

I. GROSS INCOME.

A citizen of the United States, a resident of the United States, and a domestic corporation are required to include in their gross income all foreign as well as domestic income, regardless of where it is received.

Exemption for Non-Resident Citizens concerning Earned Income.

Citizens of the United States are taxable with respect to compensation for services rendered, irrespective of the status of the taxpayer or the place where the services are rendered. This rule applies also to aliens who are residents of the United States. Of course, if an alien resident loses his status as resident, his compensation is not subject to Federal income tax unless his services are rendered within the United States.

Citizens of the United States who are away from the United States for more than six months of the taxable year are not required to include, in their gross income, income from sources without the United States which constitutes earned income (Sec. 116(a)). There is no limitation placed on the amount of earned income which may be excluded from gross income under Section 116(a) (G.C.M. 1405, C.B. VI-1, page 58).

A citizen of the United States who is engaged in a trade or business may also claim the benefit of Section 116(a) if

(a) He was away from the United States for more than six months of the taxable year; and

(b) If he actually rendered services without the United States.

If the business consists principally in rendering personal services and the employment of capital is not necessary but is merely incidental and the earnings are to be ascribed primarily to the activities of the owner, the entire net profits of the business may be treated as earned income (I.T. Mim. 3283, C.B. IV-1, page 14). A citizen of the United States who meets the requirements of (a) and (b) may exclude from his gross income his entire earned income—that is, his entire net profits from such business.

If the business is one in which capital as well as personal services is a material income-producing factor, a citizen of the United States may treat as earned income 20 per cent of the net profits from such business if such amount is a reasonable compensation for his services. If he meets the requirements of (a) and (b), such earned income, regardless of amount, may be excluded from his gross income (I.T. 2286, C.B. V-1, page 52, G.C.M. 396, C.B. V-2, page 37).

In referring to earned income, whether for the purpose of computing the earned income credit, or for the purpose of excluding earned income under Section 116(a), it makes no difference whether the taxpayer is the owner of the business or is one of the members of a partnership engaged in the business.

2. COMPUTATION OF TAXABLE INCOME.

The total amount of the items of gross income of a citizen or resident of the United States, or a domestic corporation, constitutes the total amount of such taxpayer's gross income. From the total amount of gross income is deductible the total amount of the deductions from gross income allowed to such taxpayers under the provisions of Sections 23 and 118.

A citizen of the United States, who excludes from his gross income earned income from sources without the United States under Section 116(a), may not deduct from his ordinary gross income any deductions properly allocable to, or chargeable against, his earned income, which is excluded from his gross income.

Credits against Net Income.

A citizen of the United States and a resident of the United States are permitted to deduct from their total net incomes for the purpose of computing the normal tax, but not the surtax, the following items:

(a) *Dividends.* — The amount received as dividends:

(1) From a domestic corporation, or

(2) From a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per cent of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of Section 119.

Such credit shall not be allowed in respect of dividends received from a corporation organised under the China Trade Act, 1922, or from a corporation which under Section 251 is taxable only on its gross income from sources within the United States by reason of its receiving a large percentage of its gross income from sources within a possession of the United States.

(b) *Interest on United States Obligations.* — The amount received as interest upon obligations of the United States which is included in gross income under Section 22.

(c) *Personal Exemption.* — In the case of a single person, a personal exemption of \$1,500 ; or, in the case of the head of a family or a married person living with husband or wife, a personal exemption of \$3,500. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be \$3,500. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them.

(d) *Credit for Dependents.* — \$400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under 18 years of age or is incapable of self-support because mentally or physically defective.

(e) *Change of Status:*

(1) The credit for dependents shall be determined by the status of the taxpayer on the last day of his taxable year.

(2) The personal exemption allowed by subsection (c) of this section shall, in case the status of the taxpayer changes during his taxable year, be the sum of an amount which bears the same ratio to \$1,500 as the number of months during which the taxpayer was single bears to twelve months, plus an amount which bears the same ratio to \$3,500 as the number of months during which the taxpayer was a married person living with husband or wife or was the head of a family bears to twelve months. For the purpose of this paragraph, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered as a month.

(3) In the case of an individual who dies during the taxable year, the personal exemption and the credit for dependents shall be determined by his status at the time of his death, and, in such case, full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the taxable year (Sec. 25).

Domestic corporations for the purpose of computing the income tax are allowed the following credits :

In the case of a domestic corporation, the net income of which is \$25,000 or less, a specific credit of \$3,000 ; but, if the net income is more than \$25,000, the tax imposed by Section 13 shall not exceed the tax which would be payable if the \$3,000 credit were allowed, plus the amount of the net income in excess of \$25,000 (Sec. 26).

3. COMPUTATION OF THE TAX.

Citizens of the United States and residents of the United States are liable to a normal tax levied upon their net incomes equivalent to the sum of the following :

(a) $1\frac{1}{2}$ per cent of the first \$4,000 of the amount of the net income in excess of the credits against net income provided in Section 25 ;

(b) 3 per cent of the next \$4,000 of such excess amount ; and

(c) 5 per cent of the remainder of such excess amount (Sec. 11).

In addition, the net incomes of citizens of the United States and residents of the United States are subject to graduated surtaxes levied upon their net incomes ranging from 1 per cent on net incomes in excess of \$10,000 to 20 per cent on net incomes in excess of \$100,000 (Sec. 12(a)).

In the case of a *bona-fide* sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by Section 12 attributable to such sale shall not exceed 16 per cent of the selling price of such property or interest (Sec. 102).

In lieu of computing the taxes on the profits derived from the sale or exchange of capital assets at the normal tax and surtax rates referred to, a citizen of the United States or a resident of the United States may, at his option, subject such profits to a flat rate of 12½ per cent. The term "capital assets" for the purpose of this tax means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock-in-trade of the taxpayer or other property of a kind which would properly be included in his inventory on hand at the end of the taxable year, or property held by him primarily for sale in the course of his trade or business (Sec. 101).

The net income of a domestic corporation in excess of the credits against net income provided in Section 26 is subject to tax at the rate of 12 per cent.

Credits against Tax.

A citizen of the United States, a resident of the United States and a domestic corporation are allowed a relief for the amount of income tax which they are required to pay to a foreign country or to a possession of the United States, by deducting such tax from the Federal tax. The following are the provisions of Section 131 relating to such credits :

"(a) *Allowance of Credit.* — The tax imposed by this title shall be credited with :

"(1) *Citizen and Domestic Corporation.* — In the case of a citizen of the United States and a domestic corporation, the amount of any income, war profits and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

"(2) *Resident of United States.* — In the case of a resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

"(3) *Alien Resident of United States.* — In the case of an alien resident of the United States, the amount of any such taxes paid or accrued during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

"(4) *Partnerships and Estates.* — In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be.

"(b) *Limit on Credit.* — In no case shall the amount of credit taken under this section exceed the same proportion of the tax (computed on the basis of the taxpayer's net income without the deduction of any income, war profits, or excess profits tax any part of which may be allowed to him as a credit by this section), against which such credit is taken, which the

taxpayer's net income (computed without the deduction of any such income, war profits or excess profits tax) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year.

“(f) *Taxes of Foreign Subsidiary.* — For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under Section 23 (f)) in any taxable year shall be deemed to have paid the same proportion of any income, war profits or excess profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: Provided, that the credit allowed to any domestic corporation under this subsection shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term ‘accumulated profits’, when used in this subsection in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war profits, and excess profits taxes imposed upon or with respect to such profits or income; and the Commissioner, with the approval of the Secretary, shall have full power to determine from the accumulated profits of what year or years such dividends were paid: treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits or earnings. In the case of a foreign corporation, the income, war profits and excess profits taxes of which are determined on the basis of an accounting period of less than one year, the word ‘year’ as used in this subsection shall be construed to mean such accounting period.

“(g) *Corporations treated as Foreign.* — For the purpose of this section the following corporations shall be treated as foreign corporations:

“(1) A corporation entitled to the benefits of Section 251, by reason of receiving a large percentage of its gross income from sources within a possession of the United States;

“(2) A corporation organised under the China Trade Act, 1922, and entitled to the credit provided for in Section 261.”

The tax for which a credit is sought must be an income, war profits or excess profits tax.

The Bolivian tax on mining profits is an income tax for purposes of the credit for foreign taxes, although limited to income from one source (I.T. 2070, C.B. III-2, page 250).

The tax imposed by Brazil on income of a corporation computed by the optional method is allowable as a credit, because under the law of that country a tax so computed is a tax on net income (G.C.M. 800, C.B. V-2, page 75).

The 8 per cent tax levied by the Republic of Cuba under the provisions of the Act of July 31st, 1917, upon “all common right associations, industrial or mercantile, organised or to be organised in Cuba, and in foreign countries, for the cultivation, and exploitation of tobacco and sugar”, is held to be a profits tax (I.T. 1522, C.B. O-2, page 199).

The 8 per cent tax imposed by the Republic of Cuba on the net profits of corporations with a “share capital” is an income tax (G.C.M. 7629, C.B. IX-1, page 146).

The tax imposed by France under the income tax laws of France at income tax rates upon an amount arbitrarily fixed as seven times the rental value of the taxpayer is an income tax (I.T. 2485, C.B. VIII-2, page 252).

The *chiffre d'affaires* taxes of France imposed on bankers or individuals or corporations selling goods which they have manufactured and purchased are not income taxes (G.C.M. 8478, C.B. IX-41, page 2).

Taxes paid Mexico under its profits of associations and enterprise tax are allowable as a credit (I.T. 2188, C.B. IV-2, page 82).

Peruvian taxes on sugar exported are export taxes and may not be claimed as a credit (I.T. 2499, C.B. VIII-2, page 325).

The Republic of Cuba imposes on all corporations operating sugar plantations in Cuba a tax of a certain amount on each bag of sugar produced. Apparently this tax is based on production, not on income, and is in the nature of an excise tax (O.D. 372, C.B. No. 2, January-June 1920, page 115).

A credit for foreign income, war profits or excess profits taxes is allowable only if the tax is imposed by a foreign country—that is, a composite whole made up of all the subdivisions of foreign States subject to the same central control. A subdivision thereof is not a country but merely a part of a country. The term “foreign country” includes within its meaning any foreign sovereignty or self-governing colony (for example, the Dominion of Canada), but does not include a subdivision thereof (as, for example, a province of British Columbia) or a foreign municipality (as, for instance, Montreal) (Art. 692, O.D. 1050, C.B. No. 5, July-December, 1921, page 194).

The term “foreign country” does not include Tasmania, South Australia, Western Australia and New South Wales, and, therefore, no credit can be taken for income taxes paid to these countries, but such taxes are deductible as business expenses. The Union of South Africa, however, is a foreign country (S.M. 1614, C.B. III-1, page 227).

An alien resident within the United States is entitled to a credit for taxes paid to a possession of the United States, but is allowed the credit for foreign taxes only in case that he is a citizen or subject of a foreign country which allows a similar credit to citizens of the United States residing in such foreign country.

The following is an incomplete list of the countries which satisfy the similar credits requirement of Section 131(a) (3), either by allowing to citizens of the United States residing in such country a credit for the amount of income taxes paid to the United States, or in imposing such taxes, by exempting from taxation the income received from sources within the United States by citizens of the United States residing in such countries:

Australia	Canada	Netherlands
Austria	Italy	Newfoundland
Bulgaria	Mexico	Salvador

The following is an incomplete list of the countries which do not satisfy the similar credits requirement of Section 131(a) (3), either because such countries do not allow any credit to citizens of the United States residing in such countries for the amount of income taxes paid to the United States, or because such countries do not impose any income taxes:

Argentina	Costa Rica	Great Britain and
Bahamas	Czechoslovakia	Northern Ireland
Belgium	Dutch Guiana	Guatemala
Bermuda	Ecuador	India
Bolivia	Egypt	Irish Free State
Brazil	Finland	Jamaica
Chile	France	Japan
China	Germany	Morocco

New Zealand	Peru	Straits Settlements
Nicaragua	Portugal	Sweden
Panama	Roumania	Switzerland
Paraguay	Santo Domingo	Venezuela
Persia	Siam	

(Art. 695 and I.T. 2410, C.B. VII-1, page 110).

Limitation of the Credit for Tax. — The tax paid to a foreign country or a possession of the United States for which credit is sought may be a tax paid directly by the taxpayer or his duly authorised agent, or a tax withheld by the payer of the income, or, in the case of a domestic corporation which owns the majority of voting stock of a foreign corporation, the tax paid to the foreign country or possession of the United States by the foreign subsidiary on its accumulated profits. In all three cases there is a limitation on the actual amount of credit which is allowable, depending upon the proportion which the taxpayer's net income from sources without the United States bears to his entire net income from all sources. For instance, if 50 per cent of his total net income is derived from sources without the United States, he may deduct from his Federal tax that portion of the foreign tax which does not exceed 50 per cent of his Federal tax. The method of computing the credits for foreign taxes may be expressed by the following formula :

$$\text{Maximum credit} = \frac{\text{Net income from sources without the United States}}{\text{Total net income}} \times \text{United States tax on total income}$$

In the case of an income, war profits or excess profits tax paid to a foreign country or a possession of the United States by an individual, either directly or by having the tax withheld, that portion of the tax which cannot be taken as a credit on account of the limitation prescribed in Section 131(b) may be deducted from the taxpayer's net income. The following is an example of the method of computing the tax and the credit in the case of an unmarried citizen of the United States whose net income, consisting of rents and interest, amounted to \$100,000, of which \$50,000 was derived from sources without the United States. He paid a tax of \$15,000 to a foreign country.

Total net income	\$100,000.00
Less: Personal exemption	<u>1,500.00</u>
	\$98,500.00
	<u>4,000.00</u>
	\$94,500.00
	<u>4,000.00</u>
	\$90,500.00
Tax at the rate of 1½ per cent on \$4,000	\$60.00
Tax at the rate of 3 per cent on \$4,000	120.00
Tax at the rate of 5 per cent on \$90,500	<u>\$4,525.00</u>
Total normal tax	\$4,705.00
Surtax on \$100,000	<u>11,660.00</u>
Total tax	\$16,365.00

Earned net income	\$5,000	
Less: Personal exemption	<u>1,500</u>	
	\$3,500	
Tax at the rate of 1½ per cent	\$52.50	
Earned income credit, 25 per cent of \$52.50		<u>13.13</u>
Amount of tax before computing credit for foreign taxes		\$16,351.87
$\$50,000 \times \$16,351.87 = \$8,175.94$		
<u>\$100,000</u>		
Maximum credit for foreign taxes		\$8,175.94
Total foreign tax paid		\$15,000.00
Maximum credit		<u>8,175.94</u>
Amount of foreign tax deductible from gross income		\$6,824.06

Recomputation of Tax but not Credit.

Net income without deductions for foreign tax		\$100,000.00
Less: Foreign tax not allowable as credit		<u>6,824.06</u>
Total net income		\$93,175.94
Less: Personal exemption		<u>1,500.00</u>
		\$91,675.94
		<u>4,000.00</u>
		\$87,675.94
		<u>4,000.00</u>
		\$83,675.94
Tax at the rate of 1½ per cent on \$4,000		\$60.00
Tax at the rate of 3 per cent on \$4,000		120.00
Tax at the rate of 5 per cent on \$83,675.94		<u>4,183.80</u>
Total normal tax		\$4,363.80
Surtax on \$93,175.94		<u>10,363.43</u>
Total tax		\$14,727.37
Less: Earned income credit (25 per cent of \$52.50)	\$13.13	
Credit for foreign taxes	<u>8,175.94</u>	
		<u>8,189.07</u>
Balance of the due		\$6,538.30

Under the income tax laws of some foreign countries—as, for instance, France and Spain—in addition to the imposition of an income tax upon the accumulated profits of a corporation the dividends, when distributed by such corporation, are also subject to tax in the hands of the shareholders.

A domestic corporation which is the majority shareholder of a foreign subsidiary in such foreign countries may, as the result of its stock ownership, obtain a credit, not only for the amount of tax paid to the foreign country by the foreign subsidiary on its accumulated profits but also for the tax imposed by the foreign country upon the dividends when distributed. In such cases, the credit for taxes paid on the accumulated profits of the foreign subsidiary (Sec. 131(b)) and the credit for the tax paid by the parent company on the dividends distributed by its foreign subsidiary (Sec. 131(a) (1)), are computed separately; but it does not follow

that the sum of the two credits may be allowed as a credit, as the total amount of the credit is limited by the provisions of Section 131 (b), to which reference is again directed, by stating the following formula :

$$\text{Maximum credit} = \frac{\text{Net income from sources without the United States}}{\text{Total net income}} \times \frac{\text{United States tax on total income}}{\text{total income}}$$

Under the British income tax law, a British corporation pays to the British Government a tax on the basis of its profits and gains, and such tax is deducted by the corporation from the dividends paid to its shareholders. The tax which the British corporation pays, therefore, is a tax on the shareholder (S.M. 3040, C.B. IV-1, page 198).

An American corporation owning the majority stock of a British subsidiary may claim as a credit under Section 131(a) (1) the amount of tax paid to the British Government on the profits distributed to it as dividends by the British corporation. No credit may be claimed under Section 131(f) by the American corporation for British taxes paid by the subsidiary on its undistributed profits (I.T. 2401, C.B. VII-1, page 126).

Exception to the General Rule. — The income tax paid to a foreign country by an individual citizen of the United States, a bona-fide non-resident of the United States for more than six months during the taxable year, upon earned income excluded from gross income under Section 116(a) may not be claimed as a credit under Section 131 or as a deduction from gross income under Section 23 (I.T. 2294, C.B. V-2, page 62).

Credits for Tax paid at the Source.

The only income of a citizen of the United States, or a resident of the United States, which is subject to withholding is interest on bonds, notes, mortgages, deeds of trust or similar obligations which contain a tax-free covenant (Sec. 144(a) (1)), issued by a domestic corporation, a resident foreign corporation, or by a non-resident foreign corporation, if it has a paying or fiscal agent in the United States. Withholding is required from such interest paid directly to a citizen or resident of the United States or through the medium of a resident partnership, or a non-resident partnership all the members of which are citizens or residents of the United States (Art. 766).

The rate of tax required to be paid at the source by a debtor corporation with respect to interest on its tax-free obligations paid to a citizen or resident of the United States is 2 per cent (Sec. 144(a) (1)), unless the bondholder indicates on the ownership certificate, Form 1000, which is required to accompany the interest coupons when presented for collection, that he desires only 1½ per cent to be paid to the Government in his behalf (Sec. 114(a) (3) and Arts. 761 and 766).

As discussed in more detail in connection with the withholding from tax-free bond interest paid to non-resident alien individuals, the amount of tax which the debtor corporation is required to pay to the Government in behalf of its bondholders is not actually withheld from the interest. The bondholder receives his interest in full without the deduction for such tax, and the debtor corporation pays to the Government from its own funds the amount of tax required by the statute to be withheld and deducted. The total amount of the tax-free covenant bond interest is reported by a citizen or resident of the United States on his individual income tax return, and the amount of tax paid at the source in his behalf is a credit against the balance of tax due after the credits for earned income and for taxes paid to foreign countries and possessions of the United States have been deducted.

It makes no difference whether a citizen of the United States is a resident of the United States or elsewhere. In all cases, only his income consisting of corporate tax-free bond interest is subject to withholding.

The income of a domestic corporation is not subject to withholding (Art. 763).

4. RETURNS OF INCOME.

The duty of determining the amount of income tax which is to be paid by a citizen or resident of the United States is imposed, in the first instance, on the taxpayer himself. He is required to prepare and file an income tax return showing the items of income, the deductions therefrom, the credits and the computation resulting in the amount of tax which he believes to be due. Form 1040 is the form required to be filed by a citizen or resident of the United States, but, if the net income is not more than \$5,000 and consists chiefly of salaries and wages, Form 1040A is the proper form to use. There are lines prescribed on the return for the recording of income derived by the taxpayer from his trade, business or profession, salaries, wages, royalties, interest, rents, gains derived from the sale of real or personal property, dividends, amounts received from a trust, and the distributive share of the net profits of a partnership. A citizen or resident of the United States is liable for the payment of the total tax due on his income, except in cases where tax equal to 1½ per cent or 2 per cent of tax-free covenant bond interest has been paid to the Government in the taxpayer's behalf by debtor corporations.

A citizen of the United States or a resident of the United States claiming the benefit of a credit for income, war profits or excess profits taxes paid to a foreign country or to a possession of the United States is required to attach to his Form 1040 or Form 1040A, Form 1116 substantiating his claim for credit.

A domestic corporation is required to set forth the various items of its income on Form 1120 and to compute the tax thereon. If a credit for tax paid to a foreign country or to a possession of the United States is claimed, the corporation is required to attach to its return Form 1118, substantiating its claim for credit.

A domestic corporation is liable for the total tax found to be due on its return, Form 1120, as no tax is payable to the Government in its behalf by another person.

The United States, including the territories of Hawaii and Alaska, are divided into sixty-four collection districts, each one being in charge of a collector of internal revenue. A citizen of the United States, a resident of the United States, or a domestic corporation is required to file Form 1040, Form 1040A or Form 1120 with the collector of internal revenue for the district of the legal residence or principal place of business of the person making the return. Persons having no domicile or place of business in the United States are required to file their returns with the collector of internal revenue at Baltimore, Maryland (Sec. 53(b)). In general, at least one-quarter of the total amount of tax due must be paid at the time the taxpayer files his return with the collector to whom such payment is made (Sec. 56).

5. METHOD OF CHECKING FOREIGN INCOME.

The Government of the United States depends for the greater part of income tax collections on returns filed by taxpayers who simultaneously pay part of all of the tax liability shown to be due thereon. The taxpayer's return is checked and audited by the Bureau of Internal Revenue. If necessary the bureau's representatives are authorized to inspect the books and records of the taxpayer, as well as the books and records of other persons who have information with respect to the particular taxpayer's income.

In addition, the income tax law provides, in certain cases of payers and in connection with certain kinds of income, that the payer of the income shall inform the Treasury Department of the fact in sufficient detail to enable the Bureau of Internal Revenue to check the correctness of the income tax returns filed by the recipient of the income. This procedure is generally termed "information at the source". Necessarily, the provisions of the law and regulations requiring payers of income to make returns of information covering the income of other persons can be enforced only against persons within the jurisdiction of the United States.

Foreign Dividends.

Every resident foreign corporation and every non-resident foreign corporation having a paying or fiscal agent in the United States is required to file with the Bureau of Internal Revenue an information return, Form 1099, covering the payment of dividends (distributions out of earnings or profits accumulated since February 28th, 1913) made to a citizen of the United States or a resident of the United States, if the total amount paid during the calendar year equals or exceeds \$500.

A dividend paid by a non-resident foreign corporation having no paying or fiscal agent in the United States is termed a "foreign item" (Art. 816). A bank or collecting agency who accepts such foreign items for collection is required to file with the Bureau of Internal Revenue an information return, Form 1099, if during the calendar year the amount of the foreign items paid to a citizen or resident of the United States who is single amounts to \$1,500 or more, or to a citizen or resident of the United States who is married, if the total amount paid equals or exceeds \$3,500.

If stock is registered in the name of a person other than the actual owner, the record owner, upon receipt of dividends on such stock, is required to file with the Bureau of Internal Revenue a certificate, Form 1087, showing the name and address of the actual owner. Otherwise, the record owner is liable for the tax on such dividends (Art. 818).

Foreign Interest.

For the purpose of disclosing the method of checking foreign interest received by a citizen or resident of the United States, it is necessary to divide the foreign interest into the following classes :

- (1) Interest on bonds, notes or similar obligations containing a tax-free covenant, issued by a resident foreign corporation, or a non-resident foreign corporation having a paying or fiscal agent in the United States ;
- (2) Interest on bonds, notes or similar obligations not containing a tax-free covenant, issued by a resident foreign corporation or a non-resident foreign corporation having a paying or fiscal agent in the United States ;
- (3) Interest on bonds of a foreign country ;
- (4) Interest on bonds of a non-resident foreign corporation having no paying or fiscal agent in the United States ; and
- (5) All other foreign interest.

Ownership certificates, Form 1000, are required to be filed by a citizen or resident of the United States receiving foreign interest falling within class "(1)". Such ownership certificates are returns of information (Art. 814).

The payers of foreign interest falling within class "(2)" are required to file a return of information, Form 1099, with respect to payments of interest made to a citizen or resident of the United States if the total amount paid during the calendar year equals or exceeds \$1,500 and the payee is a single person ; but, if the payee is a married person, no return need be made unless the total amount paid during the calendar year equals or exceeds \$3,500.

An item of foreign interest falling within classes “ (3) ” and “ (4) ” is a foreign item (Art. 816). An information return, Form 1099, is required to be made by the bank or collecting agency accepting the items for collection from a citizen or resident of the United States who is a single person, if the total amount paid during the calendar year equals or exceeds \$1,500 ; but, if the payee is a married person, no return need be made unless the total amount paid during the calendar year equals or exceeds \$3,500.

Method of checking Foreign Income.

There is no specific form prescribed by the Bureau of Internal Revenue to be used as a return of information covering the following foreign income ;

- (a) Patent and copyright royalties and other income from personal property ;
- (b) Rents from real estate, mining royalties and similar income ;
- (c) Gains from the purchase and sale of real estate and securities ; and
- (d) Income from the carrying on of a trade or business through any person.

Checking by Fiduciary Returns, Form 1041.

Form 1041, the return required to be filed by a fiduciary, showing the computation of the net income of an estate or trust and the distribution thereof to beneficiaries, is a return of information. However, the only foreign income reported as such and segregated from the domestic income is dividends on stock of a foreign corporation. Such segregation is not carried out, however, in reporting the distribution of the net income to the beneficiaries of the trust.

Checking by Partnership Return, Form 1065.

Form 1065, the form required to be filed by a partnership showing the computation of its net income and the distribution of its profits to its members is a return of information. However, the only foreign income segregated from the domestic income is dividends on stock of a foreign corporation. Such segregation is not carried out, however, in reporting the distribution of the net profits to the members of the partnership.

Checking by Claim for Credit for Foreign Tax, Form 1116.

A citizen of the United States or a resident of the United States who has either paid directly a foreign income, war profits or excess profits tax, or who is the beneficiary of a trust or estate, or the member of a partnership which has paid such foreign tax, is required to substantiate a claim for credit by filing Form 1116. As evidence of the payment of the foreign tax, either directly to the foreign Government or through a foreign withholding agent, the taxpayer is required to submit foreign income tax receipts or statements from the foreign withholding agent, evidencing the receipt of foreign income and the payment of foreign tax.

Inspection of Books and Records.

An inspection by the representatives of the Bureau of Internal Revenue of the books and records of a citizen or resident of the United States may reveal the receipt of foreign income, and a similar revelation may be made by the inspection of the books and records of another person.

Checking Foreign Income of a Domestic Corporation.

No return of information is required to be made by any person showing the payment by any payer of income (foreign or domestic) with respect to amounts paid to a domestic corporation

except Form 1087, the form required to be filed by a record owner of stock who is not the actual owner of the stock.

If a domestic corporation has paid, either directly or through a foreign withholding agent, any income, war profits or excess profits taxes to a foreign country, the domestic corporation is required to substantiate its claim for credit for such foreign tax by filing Form 1118. As evidence of the payment of foreign tax, the domestic corporation is required to submit foreign income tax receipts or statements from foreign withholding agents as proof of the receipt of foreign income and the payment of foreign tax.

An inspection by the representatives of the Bureau of Internal Revenue of the books and records of a domestic corporation may reveal the receipt of foreign income, and a similar revelation may be made by the inspection of the books and records of another person.

C. FOREIGN AND NATIONAL INSURANCE COMPANIES.

The Act deals with insurance companies as a distinct type of taxpayer. With respect to life insurance companies and mutual insurance companies, gross income is not quite the same as gross income of ordinary corporations. All types of insurance companies are entitled, in general, to the deductions available to ordinary corporations and also certain additional statutory allowances. The specific exemption, the tax rate, and the tax credits available to insurance companies are identically the same as allowed in the case of ordinary corporations. Insurance companies are classified by the Act as (1) life insurance companies, (2) insurance companies other than life or mutual, and (3) mutual insurance companies other than life.

I. LIFE INSURANCE COMPANIES.

GROSS INCOME.

The gross income of life insurance companies consists of the aggregate gross amount of income received during the taxable year from interest, dividends and rents. The gross income of this class of organisation differs radically from that of individuals and ordinary corporations. The decidedly limited items which constitute the gross income of life insurance companies are not inclusive of all the sources of income of a life insurance company; they do not include gains from investments, nor are they broad enough to cover the catch-all provision applicable to other taxpayers—that is, “gains and profits and income derived from any source whatever”. Thus, amounts which constitute premium receipts are not gross income, and are not to be included in the return of a life insurance company.

Deductions from Gross Income.

In addition to the deductions allowed to ordinary corporations for tax-free interest which is exempt from income tax under Section 22(b), deductions for dividends, depreciation and interest on indebtedness, allowed to ordinary corporations under Section 23, under Section 203 life insurance companies may deduct the following items:

- (a) Reserve funds (4 per cent of the mean of the reserve funds held at the beginning and end of the taxable year, without any abatement on account of tax-exempt interest);
- (b) Reserve for dividends;
- (c) Investment expenses; and
- (d) Real estate expenses.

Life insurance companies are entitled to the specific exemption of \$3,000 allowed to ordinary corporations under the provisions of Section 26(b) (Sec. 203(a) (9)).

RATE OF TAX.

Life insurance companies are liable to tax at the rate of 12 per cent on their net income (Sec. 201(b) (1)).

FOREIGN LIFE INSURANCE COMPANIES.

Foreign life insurance companies holding reserve funds upon business transacted within the United States are taxed at the rate of 12 per cent under Section 201(b) (2) upon their net income from sources within the United States, as defined in Section 203(c), which is described in connection with the allocation of income of insurance companies. All business transacted by a United States branch or agency of a foreign life insurance company, for which a reserve fund is required by the laws of any State or Territory of the United States or of the District of Columbia, will be regarded as business transacted within the United States. A foreign life insurance company not doing an insurance business within the United States and holding no reserve funds upon business transacted within the United States, but which derives income from sources within the United States as defined in Section 119 is subject to the tax at the rate of 12 per cent imposed by Section 13 upon income derived from sources within the United States (Sec. 203(c) and Art. 977).

2. INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.

GROSS INCOME.

The gross income of insurance companies other than life or mutual consists of (a) the combined gross amount earned during the taxable year from investment income and from underwriting income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners and (b) gain during the taxable year from the sale or other disposition of property (Sec. 204(b) (1)).

Deductions from Gross Income.

In general, the deductions allowed to insurance companies other than life or mutual are the same as are allowed to ordinary corporations, except that, if in computing the items of gross income certain deductions are taken, these deductions are not also deductible from the net income. In addition, such insurance companies are allowed to deduct the tax-free interest which under Section 22(b) (4) is exempt from tax by ordinary taxpayers. The deduction for losses includes losses incurred on account of insurance contracts.

Such insurance companies are also permitted the benefit of the specific exemption of \$3,000 allowed to domestic corporations (Sec. 204).

RATE OF TAX.

A domestic insurance company other than life or mutual is liable to tax at the rate of 12 per cent on its net income.

FOREIGN INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.

In the case of a foreign corporation, the deductions allowed under Section 294 are only allowed if and to the extent that they are connected with income from sources within the United States (Sec. 204(d)).

A foreign insurance company other than life or mutual is liable to tax at the rate of 12 per cent on its net income from sources within the United States.

3. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

Mutual (non-life) insurance companies are taxable as ordinary business corporations—that is, their net income is determined like that of ordinary business corporations.

GROSS INCOME.

In addition, mutual marine insurance companies include in their gross income the gross premiums collected and received by them less amounts paid for reinsurance.

Deductions from Gross Income.

In addition to the deductions allowed to ordinary corporations under Section 23, mutual (non-life) insurance companies are permitted to deduct the net addition required by law to be made within the taxable year to reserve funds and the sums other than dividends paid within the taxable year on policy and annuity contracts (Sec. 208).

Mutual marine insurance companies are also permitted to deduct amounts repaid to policyholders on account of premiums previously paid by them and the interest allowed on such amounts.

Mutual insurance companies other than life and marine are also permitted to deduct the amount of premium deposits (required of their members to provide for losses and expenses) returned to their policy-holders and the amount of the premium deposits retained for the payment of losses, expenses and reinsurance reserves.

CREDITS AGAINST NET INCOME.

Such mutual insurance companies are entitled to the specific credit of \$3,000 provided by Section 26.

RATE OF TAX.

Mutual (non-life) insurance companies are liable to tax at the rate of 12 per cent upon their net income in excess of the credit against net income.

PART III. — METHODS OF ALLOCATING TAXABLE INCOME.

A. FOREIGN ENTERPRISES WITH LOCAL A BRANCHES OR SUBSIDIARIES.

I. GENERAL QUESTIONS AND METHODS OF APPORTIONMENT.

In general, alien individuals, operating individually or in partnership, and foreign corporations, having branch establishments in the United States, are required to file returns disclosing their income from sources within the United States (Secs. 217, 235). The net income is computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be), in accordance with the method of accounting regularly employed in keeping the books of such taxpayer (Sec. 41).

The income of the non-resident alien or foreign corporation is subject to the same rules of allocation as that of an American citizen or domestic corporation. The purpose of the allocation in the case of the foreign-owned enterprise is to determine the items of gross income from sources within the United States and the deductions that are to be subtracted therefrom in order to compute the taxable net income.

"Gross income" is defined by Section 22 (a) as including gains, profits and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of, or interest in, such property; also from rent, interest, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever (Sec. 22(a); Art. 51).

For the purposes of allocation, Section 119 of the 1928 Act classifies gross income under three heads:

- (a) Gross income from sources in the United States;
- (b) Gross income from sources without the United States; and
- (c) Income from sources partly within and partly without the United States.

The section also prescribes the deductions to be allocated to the items of income in each class in order to compute the net income of each class.

The taxable income from sources within the United States includes that derived in full from sources within the United States and that portion of the income which is derived partly from sources within and partly from sources without the United States which is allocated to or apportioned to sources within the United States (Art. 671).

Furthermore, gross income from sources within the United States is not limited to the items specifically mentioned in Section 119, as that section should be read in connection with Section 22(a) defining "gross income". Thus, a discount is not listed in Section 119(a), but is included in the general terms of Section 22(a), as it is compensation for the use of money and consequently represents profit to the lender (I.T. 1398, C.B. 1-2, page 149).

Inasmuch as the system of allocation is based on Section 119, it is quoted below, together with Article 682 of Regulations 74 which prescribes the method of allocating income from the production of personal property within the United States and its sale without, or *vice versa*. Other pertinent provisions in the law and regulations are cited in the subsequent discussion.

“(a) LAW AND REGULATIONS CONCERNING APPORTIONMENT.

“Section 119 of Revenue Act.

“(a) *Gross Income from Sources in United States.*

“The following items of gross income shall be treated as income from sources within the United States :

“(1) *Interest.* — Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including :

“(A) Interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein ; or

“(B) Interest received from a resident alien individual, a resident foreign corporation, or a domestic corporation, when it is shown to the satisfaction of the Commissioner that less than 20 per cent of the gross income of such resident payer or domestic corporation has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payer preceding the payment of such interest, or for such part of such period as may be applicable ; or

“(C) Income derived by a foreign central bank of issue from bankers' acceptances.

“(2) *Dividends.* — The amount received as dividends :

“(A) From a domestic corporation other than a corporation entitled to the benefits of Section 251, and other than a corporation less than 20 per cent of whose gross income is shown to the satisfaction of the Commissioner to have been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) ; or

“(B) From a foreign corporation unless less than 50 per cent of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section.

“(3) *Personal Services.* — Compensation for labour or personal services performed in the United States.

“(4) *Rentals and Royalties.* — Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises and other like property.

“(5) *Sale of Real Property.* — Gains, profits, and income from the sale of real property located in the United States.

“(b) *Net Income from Sources in the United States.*

“From the items of gross income specified in subsection (a) of this section, there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

“(c) *Gross Income from Sources without the United States.*

“The following items of gross income shall be treated as income from sources without the United States :

“(1) Interest other than that derived from sources within the United States as provided in subsection (a) (1) of this section ;

“(2) Dividends other than those derived from sources within the United States as provided in subsection (a) (2) of this section ;

“(3) Compensation for labour or personal services performed without the United States ;

“(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade brands, franchises and other like properties ; and

“(5) Gains, profits, and income from the sale of real property located without the United States.

“(d) *Net Income from Sources without the United States.*

“From the items of gross income specified in subsection (c) of this section, there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

“(e) *Income from Sources partly within and partly without the United States.*

“Items of gross income, expenses, losses and deductions, other than those specified in subsections (a) and (c) of this section, shall be allocated or apportioned to sources within or without the United States, under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some items or class of gross income ; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of

general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from :

“(1) Transportation or other services rendered partly within and partly without the United States; or

“(2) The sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States,

shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States shall be treated as derived entirely from sources within the country in which sold, except that gains, profits and income derived from the purchase of personal property within the United States and its sale within a possession of the United States or from the purchase of personal property within a possession of the United States and its sale within the United States shall be treated as derived partly from sources within and partly from sources without the United States.

“(f) *Definitions.*

“As used in this section the words ‘sale’ or ‘sold’ include ‘exchange’ or ‘exchanged’; and the word ‘produced’ includes ‘created’, ‘fabricated’, ‘manufactured’, ‘extracted’, ‘processed’, ‘cured’ or ‘aged’.

“*Regulations for Apportionment—Personal Property produced and sold.*

“Article 682 of Regulations 74 contains the following provisions for determining the portion of income from the sale of personal property derived from sources partly within the United States and partly within a foreign country, which is attributable to sources within the United States :

“‘Personal property produced and sold. — Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country, or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States shall be treated as derived partly from sources within the United States and partly from sources within a foreign country under one of the cases named below.

“‘As used herein the word “produced” includes created, fabricated, manufactured, extracted, processed, cured, or aged.

“‘Case 1 A. — Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the Commissioner that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling

department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return.

“ Case 2 A. — Where an independent factory or production price has not been established as provided under Case 1 A, the net income shall first be computed by deducting from the gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, the expenses, losses or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States, and the denominator of which consists of the value of the taxpayer's property both within the United States and within the foreign country. The remaining one-half of such net income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within the United States and within the foreign country. The term “gross sales of the taxpayer within the United States” means the gross sales made during the taxable year which were principally secured, negotiated or effected by employees, agents, offices, or branches of the taxpayer's business resident or located in the United States. The term “gross sales” as used in this paragraph refers only to the sales of personal property produced (in whole or in part) by the taxpayer within the United States and sold within a foreign country or produced (in whole or in part) by the taxpayer within a foreign country and sold within the United States, and the term “property” includes only the property held or used to produce income which is derived from such sales. Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion or other purposes of taxation shall be the highest amount at which so valued or appraised and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis. Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch or agent in the United States.

“ Case 3 A. — Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the processes or formulas herein prescribed the income derived from sources within the United States. ”

(b) DISCUSSION OF LEGISLATIVE AND ADMINISTRATIVE PROVISIONS.

Income definitely allocable.

Broadly speaking, the system of allocation contained in Section 119 consists in analysing the accounts of an enterprise and allocating such items as (1) interest to the residence of the debtor; (2) dividends, in general, to the country in which the corporation paying them was organised; (3) compensation for personal services to the place where the services were performed; (4) rentals and royalties to the situs of the property or the place in which it was used; and (5) income from the sale of real property to the country in which such property was located. The gross income thus derived constitutes gross income from sources in the United States or gross income from sources without the United States, depending upon whether the sources indicated were in the United States or within a foreign country (Sec. 119(a) and (c)).

Deductions from Gross Income. — From the items of gross income thus allocated to sources in the United States, there are deducted the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, is included in full as net income from sources within the United States (Sec. 119 (b)).

From gross income from sources without the United States similar deductions are made in order to determine net income from sources without the United States (Sec. 119 (d)).

Income from Sources partly within and partly without the United States.

Items of gross income, expenses, losses and deductions, which are not specified as being from sources within or without the United States, are allocated or apportioned to sources within or without the United States, in accordance with the provisions in the regulations.

The law nevertheless establishes certain guiding principles. Where items of gross income are separately allocated to sources within the United States, the same deductions are to be made as those previously described in connection with arriving at the net income from sources specifically indicated as being within the United States (Art. 119 (c)).

The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the Commissioner that, due to the peculiar conditions of productions and sale in a specific case or for other reasons, all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources within the United States and to sources without the United States shall be made as provided in Article 682.

Income from Transport Services and Sale of Personal Property.

In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income: and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary.

It is specifically provided that the treatment just described shall be applied to gains, profits and income from the sale of personal property (for example, raw materials or manufactured products) produced by the taxpayer within and sold without the United States, or produced by him without and sold within the United States, as well as from transportation or other services partly within and partly without the United States (Sec. 119(e)).

Personal Property purchased and sold.

Where personal property is purchased within a foreign country and sold within the United States, or purchased within the United States and sold in a foreign country, the gains, profits and income so derived are treated as derived entirely from sources within the country in which sold (Sec. 119(e)).

This provision in the regulations has been interpreted by a General Counsel's Memorandum concerning where the sale is made. For determining the place of sale in deciding the source of income, the substance of the sale is the agreement to sell (*Compania General de Tabacos de Filipinas v. Collector*, 279 U.S. 306, 49 S.Ct. 304, 7 Am. Fed. Tax Rep. 8858). This decision is regarded as "conclusive and the technical rules as to the passing of the property in the goods and the assumption of risk are not determinative of the place of sale and the source of income from the sale of goods. The essential character of the transaction—the contract of sale—is the decisive factor in determining the place of sale for the purpose of determining the source of income" (G.C.M. 8594, IX-44-4819).

Prior to this ruling, it was generally held that the income arose where the title to the goods passed to the purchaser.

In the case considered in the memorandum, the taxpayer was a co-partnership organized under German law and having its principal place of business in South America. Its practice was for its principal office to cable the quantity and prices of hides and wool offered for sale to its representative in the United States, who would submit these offers to prospective buyers in the United States. Bids received were cabled to the principal office by its representative, who, upon receipt of cable acceptance, sent a letter to the purchaser confirming the sale on account of the taxpayer. As the contract was closed in the United States, it was held that the place where the goods were sold, and therefore the source of the income, was the United States.

Personal Property produced and sold.

Independent Factory Price. — Where personal property is produced without and sold within the United States, or *vice versa*, Article 682 provides, first of all, that the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department of the business at an independent factory price, provided such price has been fairly established by sales to wholly independent distributors or by other means unaffected by considerations of tax liability.

Fractional Method if no Independent Factory Price. — Where an independent factory or production price has not been established, a method is authorized which may be described as fractional apportionment on the basis of property and gross sales. First, the net income is computed by deducting from the gross income derived from the production and sale of the personal property the expenses, losses, or other deductions properly allocated thereto and a ratable part of any deductions which cannot definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half is apportioned in accordance with the value of the taxpayer's property within the United States and within the foreign country which is used in such production or manufacturing, and the other half shall be apportioned in accordance with the gross sales made by the taxpayer within the United States and within the foreign country of the goods so produced or manufactured.

Option of Assessment on Regular Books of Account. — Nevertheless, the taxpayer in the above case may apply for permission to base his return upon his books of account if, in good faith and unaffected by considerations of tax liability, he regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the preceding methods the income derived from sources within the United States.

Except for a special formula evolved for use in the case of shipping companies (Art. 683), and another for determining the taxable income of foreign life insurance companies (Sec. 203(c)), neither of which is used much in practice, the above-described system of allocation applies to all kinds of foreign enterprises operating in the United States and domestic enterprises operating both in the United States and in foreign countries.

Empirical Methods sometimes employed.

In practice, two empirical methods may be employed in facilitating the determination of income, but not as a substitute method for determining income, except where books of account are lacking or are very inadequate and incomplete. This occurs very rarely. In the case of mercantile enterprises, the tax officials may resort to a comparison of the percentage of net income to gross sales realised by similar enterprises in order to effect an adjustment of the tax return and accounts of the taxpayer. This method is authorised by the general authority of the Commissioner under Section 41 to compute the net income of the taxpayer in accordance with a method which reflects the income more clearly than that employed by the latter. In the case of railroad and motor-bus-lines, the factor of mileage within and without the United States may be considered.

Separate Accounting: Basic Rule.

It is evident from the preceding summary of the provisions in the United States Revenue Act that foreign enterprises having branch establishments in the United States are taxed, as a general rule, on the basis of a return referring exclusively to income from sources within the United States. While there is no provision in the law to this effect, the return is ordinarily made on the basis of accounts which show only income derived from United States sources. In practically all cases, it is possible to allocate the various items of taxable income to a definite source within the United States. Even in the case of purely mercantile enterprises, or industrial and mercantile enterprises, which carry on the bulk of international business, the rules for allocating gross income are relatively simple. Where goods are purchased and sold, the entire profit is allocated to the country of sale. Where goods are produced and sold, an independent factory profit is allocated to the country of production and a sales profit to the country of sale, provided the accounts of the taxpayer properly show this division of profits. It is in the determination of what constitutes an independent factory price that difficulties have sometimes arisen.

Allocation of Deductions.

The rules for allocating deductions for expenses, losses, bad debts and the like are, for the most part, simple; but, in practice, the allocation of certain deductions is more difficult than the allocation of items of gross income. Most items of expense can be allocated to a definite source of income within or without the United States. Serious problems have been encountered, however, in connection with determining what is a ratable part of the general overhead expense of the home office of a foreign enterprise that should be allocated to the branch in the United States. The same difficulty arises in fixing the ratable part of the interest on its general indebtedness which a foreign enterprise may allocate to its United States branch, or that part of its home tax on United States income which may be deducted therefrom in computing the tax owed to the United States (Sec. 23(c)).

Deduction for General Overhead. — The provision under which a part of the general overhead of a foreign enterprise, such as salaries of executive officers and interest on bonded indebtedness, may be deducted in computing net income from United States sources is the provision in Section 119(b), which allows as a deduction from gross income from the United States sources

“ a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income ”.

This ratable part is based upon the ratio of gross income from sources within the United States to the total gross income (Art. 680). A similar provision in Section 119(d) authorises the allocation of a ratable part of the general overhead of a domestic enterprise to foreign branches, but this is seldom done, one reason being that, in practice, foreign tax administrations are generally unwilling to allow such deductions.

Deduction for Foreign Taxes on United States Income. — The fundamental provision concerning the deduction for foreign taxes is in Section 23(c) of the 1928 Act, which allows as a deduction in computing net income :

“ Taxes paid or accrued within the taxable years, except (2) so much of the income, war profits, and excess profits taxes imposed by the authority of any foreign country—as is allowed as a credit under Section 131.”

In the case of a non-resident alien individual or foreign corporation, the deductions are allowed only if and to the extent they are connected with income from sources within the United States (Secs. 213 (a) and 232). As a non-resident alien or foreign corporation is not entitled to any credit under Section 131, the income, war profits and excess profits taxes paid during the taxable year to a foreign country, in connection with income from sources within the United States, are deductible from gross income.

Under Section 119(b), taxes (as deductible expenses) are to be apportioned or allocated to those items of gross income to which they relate in all cases where the actual amount of tax paid with respect to those particular items of gross income can be determined. It is only where such determination cannot be made that it ever becomes necessary to compute the “ ratable part ” of the tax that is deductible.

Although applying in respect of all foreign income taxes, General Counsel's Memorandum 3179, C.B. VII-1, page 240, which refers specifically to British taxes, concludes :

“ The receipt given to the taxpayer for tax deducted at the source or upon payment of income will disclose the source of the income. If the income was taxable income from sources within the United States, the tax withheld is deductible in its entirety in computing net income subject to United States tax, provided no part of the tax withheld has been repaid or credited on computing tax payable directly. Tax deducted upon payment of income is considered to be paid at the time the tax is deducted.

“ The amount of British income tax charged directly with respect to taxable United States income contained in any assessment under Schedule D for a given taxable year is the same proportion of the total tax paid on such assessment which the taxable United States income contained in the assessment (on which the tax was charged) bears to the total amount of the income contained in the assessment.

“ The amount of supertax paid on taxable United States income for a given taxable year is the same proportion of the total supertax for such year which taxable United States income contained in the assessment (on which the super-tax was charged) bears to the total amount of income contained in the assessment.

“ A non-resident alien who claims a deduction on account of British income tax and super-tax paid on United States income should not only be required to submit receipts showing the payment of such taxes, but, in cases where the tax paid on United States income is included in tax on income from other sources, to submit evidence to prove what proportion the taxable United States income bears to total income on which the tax was paid. Such evidence may consist of statements secured from the appropriate inland revenue authorities, supplemented where necessary by statements of the taxpayer.”

(c) PROVISIONS REGARDING ACCOUNTING METHODS.

The net income of a foreign enterprise's subsidiary company or branch establishment in the United States, like that of any other taxpayer, is computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be), in accordance with the method of accounting regularly employed in keeping the books of such taxpayers. If no method of accounting has been regularly employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as, in the opinion of the Commissioner of internal revenue, does clearly reflect the income (Sec. 41).

The fixed period with respect to which net income must be computed is usually twelve months, and is known as the taxable year. Items of income and of expenditures which, as gross income and deductions, are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such manner as clearly reflects the taxpayer's income (Art. 321).

Consequently, books of account are only evidence in determining what is net income, and, if they conflict with actual facts, the latter are to be followed.

The United States Revenue Act recognises that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income, and must therefore maintain such accounting methods as will enable him to do so. Certain essentials are nevertheless indicated by Regulations 74, Article 323, as follows :

“(1) In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see Sec. 22(c) and Arts. 101-108) ;

“(2) Expenditures made during the year should be properly classified as between capital and expense—that is to say, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account ; and

“(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expense.”

Cash and Accrual Accounting.

The accounting of a taxpayer may be on either a cash or accrual basis, subject in either case to the condition that it clearly reflects the income. Accounting on the cash basis means that the net income must be determined by including all the gross income actually received and deducting only the amounts actually paid out (Appeal of Consolidated Asphalt Company, 1 B.T.A. 79). Where the cash basis is used, income constructively received must also be included (Art. 332).

An accounting system is said to be on an “accrual basis” if income is taken into consideration when earned, even though not paid in cash, and expenses are considered as soon as

incurred, whether paid or not (Clarence Schock, 1 B.T.A. 528 ; Appeal of Owen-Ames-Kimball Company, 5 B.T.A. 921).

A system of accounting which combines the cash and accrual bases is inconsistent and not generally allowed for Federal tax purposes. It is admitted, however, that no system of accounting will be entirely on an accrual basis (Niles Bement Pond Company v. United States, 67 Ct. Cl. 693, 7 Am. Fed. Tax Rep. 9128).

All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. Appreciation in value of property, however, is not even an accrual of income to a taxpayer prior to the realisation of such appreciation through sale or conversion of the property (Art. 322).

Rules regarding Foreign Exchange.

Income subject to the Federal tax should be expressed in terms of United States money, at the rate of exchange on the date of receipt (O.D. 419 ; C.B., No. 2, January to June 1920, page 60 ; O.D. 459 ; C.B. No. 2, January to June 1920, page 60 ; O.D. 1058 ; C.B. No. 5, July to December 1921, page 58).

Where merchandise is purchased abroad and payment is to be effected in foreign currency, the cost is determined by converting the foreign currency into dollars at the rate of exchange prevailing on the date of purchase. Where merchandise was purchased abroad in pounds sterling on credit and paid for later at a different rate of exchange, it was held that the credit transaction was an investment or speculation in foreign exchange and that a taxable gain or deductible loss occurred when payment was made. The gain or loss is the difference between the purchase price in pounds sterling reduced to dollars at the rate of exchange prevailing on the day of purchase and the cost in dollars of the exchange remitted in payment (Joyce-Koebel Company, 6 B.T.A. 403).

(d) METHODS OF ALLOCATION.

1. *Method of Separate Accounting.*

As previously indicated, the income is determined separately as a basic principle and returns are required to be filed on that basis. The income is checked by inspection of the books and analysis of profit and loss statements in connection with balance-sheets.

2. *Empirical Methods.*

If the books of a mercantile enterprise are unsatisfactorily kept or an analysis of income based upon them indicates the possibility of diversion of profits through arbitrary shifting of income to other countries, the gross sales of the enterprise are examined and the net income reasonably corresponding thereto is determined by application of percentages of net income to gross sales compiled by the Government for various classifications of business. This method is employed largely as a working argument with the taxpayer in seeking to develop further facts which will permit determination of the net income on the basis of adjustments to accounts.

Sometimes the tax officials make an analysis of the world business of the taxpayer, based on statements by the taxpayer himself, solely with the object of developing further facts as to operations within the United States permitting an adjustment of accounts to a reasonable basis.

The power of the Commissioner under Section 45 to "distribute, apportion, or allocate gross income or deductions" between an American subsidiary and a foreign parent company to prevent tax evasion or clearly to reflect their respective income has been previously described.

3. *Method of Fractional Apportionment.*

As previously indicated the income of an American subsidiary of a foreign company is always determined separately and never as a fraction of the income of the foreign parent.

With regard to branches of foreign companies, there are only three instances in which the fractional method is authorised and, in practice, such method is seldom employed. The three instances are as follows :

(1) Where goods are produced within and sold without the United States, and an independent factory or production price has not been established under Case 1A of Article 683, the net income is apportioned in accordance with the formula described under Case 2A—*i.e.*, by prorating one-half in accordance with the value of the taxpayer's property within the United States and within the foreign country, which is used in the production and sale, and the other half in accordance with gross sales of the taxpayer within the United States and within the foreign country.

In practice, however, before resorting to this fractional method, the tax authorities frequently apply the percentage method in order to bring about an adjustment of accounts on the basis of an independent factory price. Consequently, the fractional method is seldom employed, although it has been used with reasonable success where other methods have failed, notably in cases where tobacco or fruit has been grown, or base minerals have been mined, in a foreign country and sold in the United States.

In any event, the taxpayer may apply to be assessed on the basis of his regularly kept books of account if they show taxable income more clearly than the fractional method.

(2) A fractional method is authorised for use in the case of shipping companies by Article 683, which is quoted in the detailed discussion relative to shipping companies under Question 5(c) (2). It need not be employed, however, where the taxpayer asks to have its return based upon its regularly kept books of account which show a detailed allocation of receipts and expenditures reflecting more clearly than the fractional method the income from United States sources (Art. 683(5)). The fractional method is of little importance, however, as the profits of most foreign shipping companies are exempt from United States tax, because their countries assure a reciprocal exemption as contemplated by Sections 212(b) and 231(b).

(3) Only in the case of foreign life insurance companies is the sole method prescribed—that of apportioning to the United States a part of the total net income of the company, the basis being the ratio of reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States to the reserve funds held by it at the end of the taxable year upon all business transacted (Sec. 203(c)). There is seldom occasion to apply this fraction, however, as there are very few foreign life insurance companies operating in the United States. This matter of insurance companies is discussed in greater detail on pages 255 to 257.

The fractional methods under both (1) and (2) involve the ascertainment of facts as to the property and investments of the company, and also expenditures, in foreign countries. For this purpose, information may be requested of the company involved, but it is difficult to verify. Similarly, for the purposes of the method under (3) above, foreign life insurance companies may be required to submit statements showing their total net income and the amount of reserve funds used as a basis for allocation.

In general, it is believed that fractional and empirical methods should be used only as a last resort, as in some instances they tend to spread inequalities on an even basis, whereas such inequalities should be localised and remedied through the proper keeping of accounts. In other instances they distort or throw profits where they do not belong under actual economic circumstances.

4. *Requirements for Selection and Relative Value of Methods.*

Except for transportation service and insurance companies where, as noted above, the law provides the manner of computing the income from within the United States, the Commissioner is empowered to use any method which will disclose as nearly as possible the correct income. However, as heretofore stated (see pages 248 and 249), in practice, the Commissioner, so far as possible, relies on the separate accounting method, while at the same time endeavouring to place these accounts on a reasonably fair and sound basis for allocation of income to a particular source.

The method of separate accounting, subject to verification, is the preferred method. If this method is unsatisfactory in the case of the business of buying and selling or of producing and selling, the percentage of turnover method is considered more practical as an alternative than the fractional method, because the check on the facts on which it is based can be made within the country wherein the taxable income arises, and there is, furthermore, less likelihood of error in the facts themselves and difficulty in analysing them. This method may not be technically free from error, but, for the classes of business to which it applies (*i.e.*, industrial and mercantile), it forms a reasonable substitute for fair invoicing and keeping of inventories and for a proper accounting in respect to the related business to which they apply.

The formulas employed in the case of shipping and insurance business are intended to meet particular situations and cannot be compared with methods applicable to other businesses.

(e) APPORTIONMENT BETWEEN BRANCH AND PARENT ENTERPRISE.

1. *Apportionment of Gross Profit of Branch to Real Centre of Management.*

If a foreign company with its real centre of management in a foreign country conducts operations through a branch in the United States, said company reports only its income from sources within the United States, and it follows that none of such income is ascribed to other than domestic sources. If the foreign company has a subsidiary company organised in the United States, the latter is taxable on its total net income, even if the real centre of management is in another country and no profit is ascribed to the real centre of management as such unless it is a source of income as defined in Section 119(c).

2. *Apportionment of Expenses of Real Centre of Management to Branch.*

Interest.

In case of operations carried on by a domestic subsidiary of a foreign company, the interest payable by the foreign company may not be ascribed in part to the subsidiary.

Where, however, the subsidiary borrows money and distributes the interest charge between various branch establishments, the distribution is based on the ratios of separate gross incomes to the total gross unless the facts developed show that other percentages are more nearly correct.

In case of branches of a foreign company, the interest charge on the debts of the company is, in theory, distributable between the real centre of management and the branch establishments based on relative place of employment of the funds obtained by issuance of the debentures

as determined by the facts available. A ratable part of this item is deductible from the gross income of the branch under Section 119 (b) and Article 680. In practice, foreign companies often claim this deduction, but American corporations seldom allocate a part of their interest charge to foreign branches.

General Overhead.

The provision regulating the apportionment of general overhead expenditure of a foreign enterprise is found in Section 119 (b), which states that there may be deducted from gross income from United States sources "a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. This ratable part is determined by the ratio of gross income from sources within the United States to the total gross income (Art. 680)". The type of expenditure for which this deduction is most frequently claimed is remuneration of the principal executive officers of the company.

3. *Apportionment of Net Profit of Branch to Deficitary Parent and vice versa.*

Apportionment of Net Profit of Branch to Deficitary Parent.

In the case of a domestic subsidiary of a foreign corporation, although it reports to the taxing authorities its income from all sources, the income reported must be its own income (or loss) and not that of any other company (Secs. 141 (e) and 142) (Fajardo Sugar Company, B.T.A. 20, September 25th, 1930). Consequently, in assessing the domestic corporation, no account is taken of the loss of the foreign parent corporation.

In the case of the income of a domestic branch of a foreign corporation, the return of income to the United States Government is limited to income from sources within the United States. In computing the net income returned, a part of the loss to the entire foreign undertaking may be deducted under a provision which states, in substance, that, if a portion of the loss of the foreign corporation cannot be allocated to income from sources within the United States or income from sources without the United States, a ratable portion of such loss may be deducted from its gross income from sources within the United States (Sec. 119 (b) and Art. 680). If, however, after the application of this provision, the foreign corporation as a whole suffers a net loss, whereas the branch in the United States realises a net profit, no part of the net loss of the foreign corporation can be allocated to the branch.

Apportionment of Net Profit of Branch to Deficitary Branch.

For the same reasons, no cognisance is taken of the operations of the foreign enterprise as a whole, once the fact of the net loss of the domestic subsidiary or branch is accepted. However, if it is known that the enterprise as a whole is operating at a profit, the taxing authorities would be more likely to investigate the fact of the loss within the United States and the correctness of the amount thereof by check on the various factors through which intentional or unintentional diversion of profits from one country to another is accomplished. If the loss of the domestic subsidiary results from a diversion of profits, an adjustment can be made under Section 45.

(f) APPORTIONMENT BETWEEN THE PARENT ENTERPRISE AND ITS SUBSIDIARIES.

The great majority of foreign corporations operating in the United States, as well as American corporations operating abroad, do so through subsidiary corporations. The American subsidiary of a foreign corporation is taxed as a separate entity, regardless of the extent to which it is controlled by the foreign parent corporation (A.R.M. 133, B.C. No. 4, January-June 1921). The subsidiary files a return showing total income and pays tax thereon, in the same manner as any other corporation organised in the United States.

Consequently, questions of allocation do not arise unless profits are shifted from an American subsidiary to its foreign parent (or from an American parent to its foreign subsidiary

corporation). In such a case, the Commissioner of Internal Revenue is empowered by Section 45 to allocate gross income or deductions between the two companies so as to determine the true profit from United States sources and place the transactions between them upon the same basis as if they were dealing at arm's length with each other.

Section 45 reads as follows :

“ In any case of two or more trades or businesses (whether or not incorporated, whether or not organised in the United States and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorised to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses.”

Purpose of Section 45 of Revenue Act.

A statement concerning the application of this section is contained in the reports of the Senate Committee on Finance and the House Committee on Ways and Means accompanying the revenue bill of 1928 (S. Rept. No. 960, 70th Cong. 1st sess., page 24 ; H. R. Rept. No. 2, 70th Cong., 1st sess. page 16) as follows :

“ Section 45 is based upon Section 240(f) of the 1926 Act, broadened considerably in order to afford adequate protection to the Government. The section of the new Bill provides that the Commissioner may, in the case of two or more trades or interests, apportion, allocate, or distribute the income or deductions between or among them in such manner as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of ‘ milking ’), and in order to arrive at their true tax liability.

“ It has been contended that Section 240(f) of the 1926 Act permits what is in effect the filing of a consolidated return by two or more trades or businesses even though they are not affiliated within the meaning of the section. Section 45 of the Bill prevents this erroneous interpretation by eliminating the phrase ‘ consolidate the accounts’.”

(The provision in the 1926 Act was based on similar provisions in Acts as far back as 1921.)

It is apparent from the reading of the above quotation that “ the purpose of Section 45 is to give the Commissioner authority to distribute, apportion, or allocate gross income or deductions between or among trades or businesses, if he determines that such action is necessary to prevent evasion of taxes by the shifting of profits, etc., and in order to arrive at their true tax liability. Where two or more trades or businesses owned or controlled by the same interests have so conducted their affairs as to result in an improper tax liability for each, or where the transactions between such trades or businesses result in tax evasion, the Commissioner is authorised (without making a consolidation of accounts) to apportion or distribute income or deductions between or among them, the distribution or allocation to be made in accordance with the facts in each particular case ” (*Internal Revenue News*, Vol. 5, No. 5, November 1930, page 16).

Transactions within Purview of Section 45.

Some of the transactions between trades or businesses which would warrant application of Section 45, with the basis of distribution depending upon the facts in each particular case, are as follows :

- (1) Products of one sold to another at abnormal prices ;
- (2) Property or equipment owned by one and rented to or used by another without charge or for a nominal or excessive charge ;

- (3) Compensation of officers or employees paid by one although the services are rendered to another ;
- (4) Supplies, fuel, water, light, etc., purchased and paid for by one and used by the other ;
- (5) Loans made by one to the other without interest ;
- (6) Excessive charges made by one to the other as patent royalties or for services ;
- (7) In general, any transaction, resulting in improper manipulation of accounts and shifting of profits (*op. cit.*, page 15).

The phrase, "owned or controlled directly or indirectly by the same interests", cannot be strictly defined, but it does not mean control of the stock or shares of the entities owning the business, but rather of the trades or businesses themselves (*op. cit.*, page 14).

II. APPLICATION OF THE METHODS OF ALLOCATION IN SPECIFIC CASES.

(a) INDUSTRIAL AND COMMERCIAL ENTERPRISES.

1. *Selling Establishments.*

Local Establishments selling in National Market.

If goods are purchased in another country and sold in the United States, the income arising from the transaction is all ascribed to the United States, the place of sale (Sec. 119(e)).

If goods are manufactured by the enterprise abroad and sold by the same enterprise in the United States, the assignment of profit may be as determined under Article 682, as follows : (1) by establishment of an independent factory price for the goods in the foreign country, or (2) by apportioning net income arising from the whole operation of manufacture and sale on the basis of property and gross sales, or (3) from regularly kept books of account covering operations in the United States which show income more clearly than the preceding methods.

In practice, the assessment is based on the books of account, which, if correct, will show a selling profit allocable to the American branch, the invoice price to the branch allowing for a factory profit to the home establishment. If the invoice price to the branch in the United States is abnormally high so as to deprive the branch of a fair profit, an adjustment in its return may be effected by applying the percentage method described on pages 248 and 249.

Where foreign countries levy a tax on the purchase in their territory of goods which are sold in the United States, double taxation results, from which there may be no relief. For example, an American taxpayer paid income tax in India on the basis of profit arbitrarily ascribed to the purchase there of raw materials which were subsequently sold in the United States. The Board of Tax Appeals held that such levy was an income tax which could be credited against the United States tax unless precluded by the limitation which, in substance, reads that the credit may not exceed the same proportion of the tax against which such credit is taken which the taxpayer's net income from sources without the United States bears to his entire net income from the same taxable year (1926 Act, Sec. 238(a) ; 1928 Act, Sec. 131(b)).

There was no income from sources without the United States, however, as the entire income from the purchase of goods without and their sale within the United States is deemed by law to arise in the United States (1926 Act, Sec. 217(e), 1928 Act, Sec. 119(e)). Consequently, double taxation resulted from the imposition of the Indian tax on a presumed profit from the purchase in India and of the United States tax on the real profit, derived from the sale in its territory. As the Revenue Act treated the income as derived from a United States source, no credit could be taken against the American tax for the Indian tax. The foreign tax could only be deducted from the taxpayer's gross income (*Burk Brothers v. Commissioner*, September 4th, 1930, 20 B.T.A. 657).

Local Establishments selling abroad.

If a foreign enterprise with its real centre of management in one State, has a branch in the United States which makes sales in a third State in which the enterprise has no permanent establishment, the profits are ascribed to the place of sale (outside the United States in the third State), unless the branch of enterprise in the United States produces or manufactures a raw product therein which is sold in the third State, in which case the allocation of income would be determined under Section 119(e). However, the establishment of one of the facts upon which this question is premised—*i.e.*, that the place of sale is in the third State, is, in practice, one of difficulty, as legal and administrative determination of the place of sale involves the development of data as to all the elements governing its definite location.

2. Manufacturing Establishments.

A profit is ascribed to the manufacturing establishment in an amount determined, by the same methods as indicated in reference to "Selling Establishments", above—namely :

- (1) Either by an independent factory price established for like sales within the United States, or,
- (2) If no such price is determined, by apportioning the income on the basis of property and gross sales, or,
- (3) By a fairer showing of the taxpayer's books of account (Art. 682).

The United States regards as taxable only the factory profit realised in its territory. The difference between the factory price at which a non-resident foreign corporation buys certain machines in the United States and the price received by such corporation from the sale in a foreign country of the machines is not income from sources within the United States and is, therefore, not subject to Federal income taxation. This is true whether the "difference" is considered commission for services rendered in the foreign country by the foreign corporation in behalf of the domestic manufacturer or whether it is considered the profits derived by the foreign corporation from the sale of machines in the foreign country (I.T. 2002 ; C.B. III-1, page 226).

3. Buying Establishments.

There is no profit assigned to any foreign enterprise merely purchasing in this country. Section 119(e) specifically provides that income derived from the purchase of personal property within and its sale without the United States shall be treated as derived entirely from sources within the country in which sold—*i.e.*, the country in which the contract of sale was concluded (G.C.M. 8594, IX-44, 4819).

Even before this rule was inserted in the Revenue Act of 1921, it was observed by the Bureau in a number of cases. For example, a British partnership purchased through its office in the United States cotton to be shipped abroad, the purchase price of which was paid by a draft drawn on England, and no cotton so purchased was sold in the United States and no proceeds of sale were received in this country. The holding was that, as the sale of goods purchased by this agency was consummated in a foreign country through transactions by the home office, it was clear that any income derived from the sale was in no way connected with the efforts of the purchasing agency maintained in the United States. Hence the income derived by the foreign partnership through a purchasing agency maintained in this country on sales in foreign countries is not subject to tax either in the hands of the partnership or the individual members thereof (1918 Act, Sec. 213 (c), Regulations 45, Art. 92 ; O.D. 592, C.B. No. 3 July-December 1920, page 128).

4. *Research and Statistical Bureaux, Display Rooms, etc.*

If a foreign enterprise has an establishment in the United States, which does not directly engage in any profit-making transactions but renders services to the enterprise which contributes indirectly to the realisation of profits (*e.g.*, a statistical bureau, a display room) ; no profit is ascribed to such an establishment. Profits are realised only where there has been a sale of goods or services by an establishment.

(b) BANKING ENTERPRISES.

Banks and banking companies are subject to the general provisions for allocation contained in Section 119. A special exemption is granted foreign central banks of issue in respect of income from bankers' acceptances (Sec. 119(a) (1) (C), Art. 672(c)).

Because of the nature of the income of banking enterprises, few questions arise as to the determination of its source, but difficulties are frequently encountered in allocating deductions for expenditures, overhead, interest charges and the like. The principal activities of international banking enterprises generally consist in receiving deposits, making loans, discounting commercial paper, engaging in exchange and arbitrage transactions, purchasing and selling bonds and other high class securities, the renting of office space in buildings which they own or lease, and the renting of safe deposit boxes. Consequently, most of their principal sources of income can be readily ascribed to a definite country, under Section 119(a) and (c).

Similarly, most of the expenditures of a banking enterprise are readily allocable to a particular country, such as rents on business property, repairs, interest on deposits, taxes, losses, bad debts, depreciation, and salaries and wages to officials and employees occupied with local business. The salaries paid to the principal executive officers and other items of general overhead, as well as various other expenses and losses may, however, give rise to questions of allocation. It is recognised that expenditures such as these must, because of their very nature, be allocated to both foreign and domestic sources. Article 680 of Regulations 74 provides for the apportionment of expenses, losses, or deductions which cannot be definitely allocated, on the basis of gross income from sources within the United States to total gross income. This method works in a satisfactory manner.

In practice, the determination of gross income from sources within or without the United States is not difficult, if accounts are kept which provide for a segregation of income and expenses attributable to domestic as distinguished from foreign sources. Thus individual items of interest and dividends can be readily allocated, but if they are lumped in accounts, regardless of which source, some arbitrary method of allocation is necessary. For this purpose, it is not practical, in the case of banks, to employ the method of assuming the net income to be the same percentage of turnover as that of similar undertakings, as, properly speaking, a bank has no turnover.

The allocation of bad debts and losses involve questions as to where they are incurred. As a rule, a bad debt is allocated to the place where the loan agreement was contracted.

(e) INSURANCE ENTERPRISES.

Insurance companies are classified in Supplement G of the Revenue Act of 1928 as (a) life insurance companies, (b) insurance companies other than life or mutual, and (c) mutual insurance companies other than life. Whereas companies in categories (a) and (b) are subject to a special income tax, mutual insurance companies other than life, except for a few special provisions, are taxed in the same manner as other corporations (Sec. 208).

Life Insurance Companies.

For the purposes of the Revenue Act of 1928, the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health and accident insurance) the reserve funds of which, held for the fulfilment of such contracts, comprise more than 50 per cent of its total reserve funds (Sec. 201 (a)).

In the case of domestic companies, inasmuch as the "gross income" for tax purposes includes only the gross amount of income received during the taxable year from interest, dividends, and rents (Sec. 202(a)), and as the sources of such income are readily determinable, there is no real problem involved in allocating gross income as between countries.

Similarly, with a few exceptions, the allowable deductions (Sec. 203) are of items that are readily allocable—for example, 4 per cent of the mean of the reserve funds required by law, 2 per cent of sums held at the end of the taxable year as a reserve for dividends, taxes and expenses paid upon real estate owned by the company, and depreciation of property. General expenses, claimed under the head of investment expenses, and interest on indebtedness may give rise to difficulties in apportionment (Sec. 203(a)).

In the case of a foreign life insurance company, an apportionment fraction is employed to determine taxable net income, as follows: the amount of its net income for any taxable year from sources within the United States is the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted (Sec. 203(c)).

There are so few foreign life insurance companies operating in the United States that there has been little occasion to test the practicability of the formula.

Insurance Companies other than Life or Mutual.

This category includes fire and marine insurance companies, which is the most important kind of foreign insurance companies operating in the United States. A special income tax is imposed on these companies, for which gross income includes investment income (interest, dividends, and rents) and underwriting income (premiums less expenses and losses), and gain from the sale or other disposition of property (Sec. 204). Inasmuch as the sources of these classes of income are almost invariably situated in the United States, no questions arise regarding allocation as between countries. Only income from United States sources is stated in the return.

Foreign corporations other than life are allowed the same deductions as are ordinarily allowed to foreign corporations (Sec. 204(d)). The principal source of difficulty in this connection is the allocation of a ratable part of the head office expenses and taxes as a deduction from the gross income of a branch in the United States.

The deduction of expenses is allowable in accordance with G.C.M. 7592, C.B. IX-1, page 213, while the tax deduction is allowable under G.C.M. 3179, C.B. VII-1, page 240. The deduction for foreign taxes paid by the head office on income from United States sources is the same as that allowed all foreign corporations.

The essential statement concerning the deduction of head office expenses in G.C.M. 7592, which involved a fire and marine insurance company, reads as follows:

"Where a foreign insurance company authorised to write several kinds of insurance has, in good faith and unaffected by considerations of tax liability, adopted a reasonable method of allocating or apportioning the overhead expenses of the company to the several departments of its business, such allocation or apportionment should be accepted. The

portion of the overhead expenses allocated or apportioned to the departments doing business in the United States should be further allocated or apportioned between the income of such departments from sources within the United States and from sources without the United States on a ratable basis. The ratable part of such expenses which may be deducted from income from sources within the United States should be determined by the ratio of the gross income of such departments from sources within the United States to the total gross income of such departments. If, however, the company has not adopted such a method of allocating or apportioning its overhead expenses, a ratable part of the total overhead expenses of all departments, based upon the ratio of gross income from sources within the United States to total gross income from all sources, may be deducted from United States income."

The information submitted by taxpayers in support of the deductions is usually inadequate. The income tax unit is compelled to rely upon affidavits and upon schedules which cannot be verified from records available in this country; nor can they be verified satisfactorily from the taxpayer's home office report. It is true that the schedules submitted are now made to reconcile with the published balance-sheets, but there is no check possible of the balance-sheets with the books.

The taxpayer makes an allocation of expenses of management as far as possible as between the home office, the United States branch, and the other branches, and the unit must rely upon the taxpayer's affidavit that the segregation is correct. It must also accept the taxpayer's affidavit as to the unallocable expenses.

It should also be noted that, in many cases, the United States branch is apparently a self-functioning unit, any supervision which the home office has over it being only nominal. Insurance contracts must be executed immediately and the branch must be in a position to pass upon them quickly and finally. There is a question therefore as to whether any deduction for head office expenses is in order. In this connection it might be stated that United States companies operating branches in foreign countries do not usually allocate any head office expenses against the gross income of the foreign branch in the determination of the foreign tax.

(d) TRANSPORTATION ENTERPRISES.

Railroad and Motor-Bus Companies.

Gains, profits and income from transportation or other services rendered partly within and partly without the United States are treated as derived partly from sources within and partly from sources without the United States, under Section 119(e) of the 1928 Act. Article 683 of Regulations 74 provides a formula for the allocation of such income which is seldom, if ever, invoked in the case of railroad or motor-bus companies, but is frequently employed in the case of shipping enterprises of countries which have not entered into arrangements for the reciprocal exemption of such profits authorized by Sections 212(b) and 231(b) of the 1928 Act, and similar provisions in prior acts. The formula will, therefore, be discussed below in connection with shipping companies.

Nevertheless, the taxpayer may apply for permission to base the return upon his books of account if, in good faith and unaffected by considerations of tax liability, he regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the process just mentioned the income derived from sources within the United States.

Practice in regard to Railroad Companies. — In practically every case, foreign railroad companies operating in the United States or American railroad companies operating in

contiguous countries do so through subsidiary companies. Consequently, income from operations within or without the United States is determined separately on the books of the subsidiary or parent company, as the case may be. A Canadian company has a short line crossing the State of Maine, but this has not presented a great problem.

Moreover, a very satisfactory check on the gross income and expenditures allocable to the United States is afforded in the statement that must be submitted annually by every railroad operating in the United States to the Interstate Commerce Commission, which prescribes the manner in which accounts are to be kept, determines rates and requires a statement of the portion of through tariff rates which is allocable to the United States.

The Commission has indirect control over the division of international through rates in that if revenues are shifted to a contiguous country in a proportion in excess of what is deemed to be required for operations and to provide a fair return, the Commission could initiate proceedings to reduce the rates charged for transportation. Division rate schedules are filed with the Commission for reference. This division of through rates made for the Interstate Commerce Commission is accepted by the Bureau of Internal Revenue. The apportionment of through rates for transportation originating in one country and destined to another is always made on an equitable basis, the mileage factor being given due consideration.

Where profits are diverted in any manner to a foreign railroad company from its American subsidiary, or to a foreign subsidiary from an American parent, their accounts may be adjusted under Section 45.

As an example of the method of allocation employed in practice, the gross revenue of a Canadian company which has about 192 miles of line in the State of Maine was allocated to the United States in the ratio of mileage in the United States to total mileage of the entire system. From this income, there was allowed as a deduction a proportionate part of the total interest accrued on obligations of the Canadian company.

In the case of a railroad connecting Canada and the United States through a tunnel, a few small items are entirely allocated to the country to which they can be definitely assigned, but substantially all the income is apportioned at the rate of 50 per cent to each country. The same method is followed in the case of a bridge connecting the two countries at Niagara Falls.

Practice in regard to Motor-Bus Companies. — With respect to motor-buses, few cases have yet come to the income tax unit, but it is the opinion of officials who would handle cases involving them that the division of revenue and expenses on a mileage basis would be equitable and have the added feature of simplicity.

Shipping Companies.

The problem of allocation has been almost eliminated in the case of shipping companies, because practically all important foreign countries have entered into arrangements for the reciprocal exemption of shipping profits under Sections 212(b) and 231(b) of the 1928 Act, or equivalent provisions of prior Acts, with the result that practically no large foreign steamship company, operating in United States waters, pays the Federal income tax. These sections state that: the income of a non-resident alien individual or a foreign corporation "which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States, shall not be included in gross income and shall be exempt from taxation" under the Act.

The following is an incomplete list of the foreign countries which either impose no income tax, or, in imposing such tax, exempt from taxation so much of the income of a citizen of the United States non-resident in such foreign country and of a corporation organized in the United States as consists of earnings derived from the operation of a ship or ships documented under the laws of the United States: Argentina, Brazil (from December 1928, only), Bulgaria, Canada,

Denmark, Egypt, France, Germany, Great Britain and Northern Ireland, Greece, Iceland, Italy, Japan, the Netherlands, Norway, Paraguay, Persia, St. Lucia, Siam, Spain, Straits Settlements, Sweden and Venezuela. The exemption accorded to Great Britain and Northern Ireland does not extend to the Irish Free State but is limited to residents of Great Britain and Northern Ireland, other than citizens of the United States, and to corporations organized under and existing by virtue of the laws of the United Kingdom (Art. 1042(a) and T.D. 4269, VIII-2, page 146, T.D. 4289, IX-1, page 160, and T.D. 4299, IX, No. 37, page 2).

The following is an incomplete list of the foreign countries which, in imposing an income tax upon the income of citizens of the United States non-resident in such countries or of corporations organized in the United States, do not exempt from taxation the earnings derived from the operation of a ship or ships documented under the laws of the United States: Antigua, Belgium, British Honduras, Costa Rica, Dominica, Fiji, Finland, Grenada, India, Jamaica, New Zealand, Peru, St. Vincent, Trinidad and Union of South Africa (Art. 1042(b)).

In cases where the reciprocal exemption provisions do not apply, Article 683 of Regulations 74, which is quoted below, contains the latest regulations, now operative, governing the method of taxation of this class of taxpayers. This article follows the rule laid down in T.D. 3387 (C.B. 1-2, page 153), under the 1921 Revenue Act, which was interpreted by I.T. 1492 (C.B. 1-2, page 154), 1570 (C.B. II-1, page 127) and 2098 (C.B. III-2, page 167), also by T.D. 4201 (C.B. VII-2, page 133). This method of determining taxable income for maritime transportation companies is based upon experience gained in attempting reasonably to apply the statute to the conditions peculiar to their business, and was drafted after prolonged study and consultation with representatives of the shipping industry. It is probably true that a great amount of data must be available to carry out the provisions of the regulations applying to this class of taxpayers as compared with others and that the method involves a somewhat tedious formula. Under the circumstances it appears to be the most practicable manner of applying the present law to steamship service in cases where an arrangement for reciprocal exemption has not been made.

The prescribed process of allocation follows:

Art. 683: Transportation Service. — A foreign corporation carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

“(1) The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (a) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (b) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services (such as the sale of money orders) shall be apportioned on the same basis as direct revenues from transportation services.

“In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with such part of the services as was wholly rendered in the United States should be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries, and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance, and supplies, chargeable to voyage expenses should ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears

to the total number of days on the voyage, and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. Income, war profits, and excess profits taxes should not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and for such purpose, interest and other expenses for the use of borrowed capital should not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the Revenue Act of 1928 should be taken.

“The value of the property used should be determined upon the basis of cost less depreciation. Eight per cent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken should be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year. Current assets should be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries should be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries should be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States should be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries. For ships, the average should be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States should be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

“(2) In computing net income from sources within the United States there shall be allowed as deductions from the gross income as determined in accordance with paragraph (1): (a) the expenses of the transportation business carried on within the United States as determined under paragraph (1), and (b) the expenses determined in accordance with paragraphs (3) and (4).

“(3) Interest and income, war profits, and excess profits taxes should be excluded from the apportionment process, as explained in paragraph (1); but, for the purpose of computing net income, there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part (a) of all interest (deductible under Section 23(b)), and (b) of all income, war profits, and excess profits taxes (deductible under Section 23(c) and (d)), paid or accrued in respect of the business of transportation services between points in the United States and points outside the United States. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income from such transportation service.

“(4) If a foreign corporation subject to this article is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses (including taxes) properly apportioned or allocated to such other business should be excluded both from the deductions and from the apportionment

process prescribed in paragraph (1) ; but, for the purpose of determining net income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income.

“(5) Application for permission to base the return upon the taxpayer’s books of account will be considered by the Commissioner in the case of any taxpayer subject to this article, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the process prescribed in paragraphs (1) to (4) the income derived from sources within the United States.”

Practice in regard to Shipping Companies. — It should be noted that books of account of these foreign corporations are not available to Government representatives under the present policy, being kept in foreign countries, and reliance must be placed upon statements submitted by the taxpayers or their representatives in this country. These statements are accepted at face value as to facts and figures disclosed by the books. However, the statements submitted in the past by the various taxpayers are not all susceptible of a degree of analysis which would ensure as a practical matter that uniformity is attained in the application of the method, taking into consideration that the same item of income or expense is treated differently on the books of different taxpayers, as for instance, in the spread of what may be called “overhead” items to the various services performed.

In the case of large steamship companies it has sometimes been possible to obtain from the taxpayer statements by reputable accounting firms disclosing figures permitting reasonable verification of the taxpayer’s methods of handling his business from the tax standpoint. These statements, although helpful, did not always completely cover the ground.

In the case of foreign steamship companies the ratable part of any general expense (such as head office overhead and debenture interest), loss or deduction pertaining to the operation of the concern as a whole which may be deducted from the gross income from sources within the United States is set forth in Article 683, paragraph (4), which states that “such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income from such transportation service”.

Where such concerns are also engaged in a business other than that of providing service between points in the United States and points without the United States, interest paid is first apportioned to the transportation service which touches the United States on a basis similar to that described above—*i.e.*, in accordance with gross income.

Air Transport Companies.

Practically no cases involving air transport companies have yet been brought to the attention of the income tax unit, but the formula contained in Article 683 would be applicable, unless the Commissioner permits the taxpayer to base his return upon his regularly kept books which reflect his income more clearly.

(e) POWER AND LIGHT AND GAS COMPANIES.

As there have been no cases of such companies operating across the boundary lines between the United States and contiguous countries, no questions of allocation have arisen. If such enterprises existed, however, the income would be regarded as arising from sources partly within and partly without the United States and therefore taxable under Section 119(e).

(f) TELEGRAPH, TELEPHONE AND RADIO COMPANIES.

Few cases of allocation have arisen, due to the fact that hardly any foreign companies are operating in the United States. If cases arose, competent officials are of the opinion that income might be apportioned on the basis of gross receipts or of expenses. American companies generally operate abroad through domestic subsidiary companies or branches, but, in practice, there have been no allocation problems.

If a company operated both within and without the United States, the part of its profits derived from rendering the service of communication between points within and points without the United States would be taxed under Section 119(e) as being derived from sources partly within and partly without the United States.

(g) MINING AND EXTRACTIVE INDUSTRIES.

The rules of allocation governing the mining and extractive industries are found in Section 119 of the 1928 Act and Article 682. In other words, where minerals are produced within and sold within the United States, or produced within and sold without the United States, the profits derived from the sale are treated as income partly from sources within and partly from sources without the United States.

The part of the income allocable to the country of production is that determined by the independent price. If no such price can be determined, the part of the net income which is allocable to the United States is determined by apportionment on the basis of property and gross sales. The taxpayer may apply for permission to base his return upon his regularly employed books of account where they show a detailed allocation of receipts and expenditures which reflects more clearly than the preceding methods the income derived from sources within the United States (Sec. 119(c), Art. 682).

There are very few foreign mining enterprises with subsidiary companies or branches in the United States, and no difficult problems have arisen in applying the rule of the independent production price in their case.

Problems have arisen, however, in connection with the taxation of American enterprises operating mines in foreign countries and selling the products in the United States. This is especially true in cases where the real centre of management of the undertaking is in New York and all the producing activities of the company are carried on at the mine in a foreign country. The question arises as to how much of the general overhead, including bond interest and salaries of officials, should be allocated to the foreign country.

Under Section 119(b) and (d), there shall be deducted from gross income from sources within the United States and from gross income from sources without the United States a ratable part of any expenses which cannot definitely be allocated to some class of gross income. Under this section, a ratable part of the general overhead of a foreign enterprise may be deducted from gross income derived by United States branches, and a domestic corporation should allocate a ratable part of their general overhead to gross income from foreign branches. Although foreign enterprises usually take advantage of this provision, American enterprises seldom allocate a part of their general overhead to the gross income of foreign branches.

Another problem is in connection with the allowance for depletion under Section 114. The Revenue Act of 1928 allows American enterprises to claim a certain depletion allowance even where the depletion takes place at a mine owned by the American enterprise in a foreign country. As very few foreign countries grant an allowance for depletion, it often happens that the net income from the mine will be much larger when computed under the provisions of the law of that country than it is under the law of the United States.

This question becomes important in so far as the United States is concerned where the American enterprise claims a credit against the American tax for income taxes paid in the foreign country where the mine is located, under Section 131. The amount of credit is limited by the proportion of income from sources without the United States to total income of the enterprise. A discrepancy often exists between the amount of income computed under the provisions of the law of the foreign country and that computed under the law of the United States.

Certain oil companies, extracting oil in one country, refining it in a second, and selling in the United States, have been able to segregate the profits of each stage of the business as there is a market price prevailing for the production at each stage. In the case of mining companies, however, the same enterprise usually handles all the stages from mining the ore and smelting it to the sale of finished products, and it has been found difficult to determine a fair market price for the product at each stage. It has been proposed as a general rule that, if the product has an established market value in the country in which produced, such value should be considered to represent gross income in such country. The difference between that value and the price at which the finished product is sold in another country should be considered as gross income to be allocated to such country.

In general, transportation, insurance, selling costs and overhead would be the main deductions allowable against this gross income in arriving at the net income taxable in the country of sale.

B. NATIONAL ENTERPRISES WITH BRANCHES AND SUBSIDIARIES ABROAD.

I. GENERAL METHODS OF ALLOCATION.

An American citizen or corporation, conducting an enterprise which extends to foreign countries, is taxable on income derived from foreign, as well as domestic sources, and, in general, there is no need separately to determine foreign income except for ascertaining the ratio of foreign net income to total net income which limits the credit for taxes paid abroad allowed against the United States tax under Section 131. For such purposes, the tax officials follow the system of allocation in Section 119, which was described above.

II. ALLOCATION OF PROFIT TO REAL CENTRE OF MANAGEMENT WITHIN THE COUNTRY.

If the corporation is organised in the United States, no profits are ascribed to the real centre of management as such, but it will report all its income from all sources on the domestic return. If no other function but management is performed in the United States, and if no sales are made in the United States of the product manufactured abroad, the income would all be ascribed to foreign sources so far as that item is concerned. Other items would similarly be allocated to their country of source. There would be a domestic tax liability in these circumstances, even though the income were 100 per cent foreign. Under the limitations of Federal income tax act, however, an offset (credit) is allowed against such domestic tax of all foreign taxes paid with respect to such foreign income, so that, if the foreign tax rate were equal to or greater than the American rate, all domestic tax liability would be extinguished.

C. HOLDING COMPANIES.

I. NATIONAL HOLDING COMPANY CONTROLLING FOREIGN SUBSIDIARIES.

In the case of a national holding company controlling foreign subsidiaries, the administration is concerned only with a check on dividends, interest, royalties or other income received by the company from its foreign subsidiaries (the element of operations by the domestic holding company in foreign countries through other than subsidiary companies is not considered here).

This check may take the form of requesting the domestic company to submit copies of transmittal or credit notices by the foreign subsidiaries showing the transaction covering the interest, dividends, royalties or other income reported on domestic returns, or it may be obtained through inspection of the same class of statements submitted by the taxpayer with the return in connection with claim for credits for foreign taxes to offset domestic taxes, together with information revealed by the foreign tax receipts themselves, especially where a dividend tax is imposed as such by the foreign countries.

In cases where dividends are received by the domestic holding company from a foreign subsidiary, over 50 per cent of whose income over a period of three years is from sources within the United States, such dividends are not subject to domestic tax (see Sec. 23(*p*)). However, it is not usual for a foreign company, controlled by a domestic company, to operate within the United States.

II. LOCAL SUBSIDIARY COMPANY CONTROLLED BY A FOREIGN HOLDING COMPANY.

The interest on funds advanced to the domestic company by the foreign holding company is ascertained from the domestic subsidiary company's books and, under conditions set out in Section 144, tax is withheld thereon and paid to the United States Government, the balance being remitted or credited net to the holding parent. The parent corporation in such case is required to file a return of the gross amount but may claim credit for the tax withheld (Secs. 233, 235, 144(*d*)).

In the case of tax-free covenant bonds, the domestic subsidiary is not allowed a deduction for the tax paid to the United States on interest due to the foreign parent, or any other tax paid pursuant to the tax-free covenant clause, nor is such tax included in the gross income of the foreign parent (Sec. 144(*a*) (4)).

The dividends distributed by the domestic company to its foreign holding parent are included in the gross income of the latter, but, as they are allowed as a deduction, they are not taxable to the latter (see Sec. 23(*p*)).

The United States tax administration is concerned in this matter only with interest paid to a foreign holding company and with the net income of the domestic subsidiary company, the ascertainment of the latter being made in the ordinary way by verification of the return from the books of the domestic corporation.

D. DIFFICULTIES AND RECOMMENDATIONS.

I. DIFFICULTIES IN TAXING FOREIGN AND NATIONAL ENTERPRISES.

(1) Difficulties arise where a diversion of profits from one country to another is suspected and where, at the same time, it would appear advisable under the circumstances to inspect the home office books in order to determine world income and world invested capital in case such items are factors in a check on reasonable profits. They are also encountered where an inspection of the books of accounts of the home office might indicate adjustments to branch books permitting determination of branch income on such revised book basis rather than on an artificial or empirical basis. These difficulties include questions of political expediency, or practical obstacles presented by (*a*) the distance necessary to be travelled, (*b*) the interpretation of the foreign language, and (*c*) an understanding of the foreign methods of keeping books.

(2) Other difficulties are those of checking costs plus reasonable profits, reflected in invoices on goods delivered by a home office in one country to its branch in another or by a

foreign company to its domestic subsidiary company; or, on the other hand, of establishing an independent factory price for the goods up to the time they are received by the branch or the subsidiary company, reflecting a reasonable profit on the raw materials and all processes added thereto up to the time of delivery to the branch or subsidiary company. Such independent factory price should be based so far as possible on known markets, established by independent arm's-length transactions.

(3) In cases of national enterprises doing business in foreign countries whose taxes under domestic assessment are credited with taxes paid to such foreign countries, it is often difficult to obtain copies of receipts, assessment notices or other forms of statement from the foreign Governments, evidencing the fact that the tax claimed has been paid or is a liability, the nature of the tax and the accrual of the income with respect to which it has been paid.

(4) Sometimes difficulties arise because of the difference in allowances under the laws of the United States and foreign countries in respect of expenses, bad debts, losses, depreciation and depletion.

II. RECOMMENDATIONS TO THE FISCAL COMMITTEE.

(1) Inasmuch as in all cases of the allocation of income to a particular country, whether the enterprise produces or processes in one country and sells in another or purchases in one country and sells in another, the place of sale is a factor recognised as of the utmost importance in any computation of the distribution to different sources, it follows that agreement as to what determines the place of sale, for purpose of tax assessments, would eliminate differences of procedure and double taxation in so far as this factor is concerned.

(2) In the case of goods being purchased in one country and sold in another, double taxation of this particular item of income would be prevented if all countries agreed that the profit of the entire transaction arises solely in the country of sale and should therefore be subject only to its tax.

(3) Where the principle is followed that income derived from the purchase and sale of goods should be taxable only in the country of sale, it is recommended that the goods purchased in the one country be invoiced to the selling establishment in the other country at the cost price.

(4) Where double taxation is avoided by a credit for foreign taxes, an agreement should be reached as to what class of taxes shall be allowed as a credit—*i.e.*, (1) like taxes or (2) all income taxes under Federal Law whether or not partially for the use and benefit of territorial subdivisions; or (3) income taxes under territorial subdivision law, for the benefit of such subdivisions.

(5) In order to facilitate the securing of relief against double taxation, which is granted under Section 131 to United States citizens and corporations and resident aliens, it would be helpful if other countries, when imposing taxes on such taxpayers, would indicate on the receipt given for the tax paid, the name of the taxpayer, the name, rate, and date of the tax, the source and amount of income, and the year of accrual of the income.

REVENUE ACTS SINCE 1921.

1921 Act — Approved November 23rd, 1931:

Sections 210 and 216, amended by Act of March 4th, 1923 (Public Document 531);
Section 202, amended by Act of March 4th, 1923 (Public Document 545).

1924 Act — Approved June 2nd, 1924.
1926 Act — Approved February 26th, 1926.
1928 Act — Approved May 29th, 1928.
House Joint Resolution 133 — Approved December 16th, 1929, changing rate for 1929 only.

INFORMATION SERVICE.

The Bureau of Internal Revenue maintains an information service for the information of taxpayers and their counsel as showing the trend of official opinion in the administration of the Bureau; the rulings other than the Treasury Decisions have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury. This service, which may be obtained on a subscription basis, consists of weekly bulletins and semi-annual cumulative bulletins.

ABBREVIATIONS.

In referring, in this memorandum, to the rulings published in the *Internal Revenue Bulletin Service*, the following abbreviations have been used:

Act — Revenue Act of the year indicated.
Art. or Article — Article in Regulations 74, concerning the income tax provisions of the Revenue Act of 1928.
A.R.M. — Committee on Appeals and Review Memorandum.
Am. Fed. Tax Rep. — American Federal Tax Reports.
B.T.A. — Board of Tax Appeals.
C.B. — *Cumulative Bulletin*.
Cong. — Congress.
Decs. — Decisions.
G.C.M. — General Counsel's Memorandum.
H.R.Rept. — House of Representatives Report.
I.R.B. — *Internal Revenue Bulletin*.
I.T.U. — Income Tax Unit.
Mim. — Mimeographed Letter.
O.D. — Office Decision.
Sec. or Section — Section in United States Revenue Act of 1928, approved May 29th, 1928.
S.M. — Solicitor's Memorandum.
S.Rept. — Senate Report.
T.D. — Treasury Decision.

ANNEX I.

PROCEDURE RELATING TO OWNERSHIP CERTIFICATES (FORM 1000) OF CITIZENS, RESIDENT INDIVIDUALS, FIDUCIARIES, AND PARTNERSHIPS, AND MONTHLY AND ANNUAL WITHHOLDING RETURNS (FORMS 1012 AND 1013).

Duties of Bondholders:

1. To procure and fill in ownership certificate (Form 1000), when coupons from tax-free covenant bonds are presented to the debtor corporation, bank or other paying agent for payment or collection.
2. To use care in entering the correct amount of the interest received (face value of the coupon) in the proper line on the ownership certificate (Form 1000). If the amount is on the first line of the certificate, it means that the bond owner is not subject to income tax and the corporation will not be required to pay any for him. The amount on the second line means that the owner of the bonds is subject to only the lowest rate of tax—namely 1½ per cent—and that the corporation will pay this amount for him. The amount on the third line means that a portion of the owner's income is subject to a normal tax at a rate higher than 1½ per cent or subject to a surtax, in which case the corporation will pay an amount equal to 2 per cent of the interest received.
3. To submit the ownership certificate with the coupon to the bank or other paying agent so that the debtor corporation may receive the coupon and the certificate at the same time.
4. To include in his income-tax return in the proper space all interest received from his tax-free covenant bonds; and to compute the tax on same as on all other types of income. After tax is computed, a credit should be claimed against the tax in an amount equal to that paid by the corporation as a result of the ownership certificates submitted.

Duties of Banks and other Paying Agents:

1. To require that ownership certificates be submitted with all coupons detached from corporate tax-free covenant bonds, except in case such bonds are actually owned by a domestic or resident corporation.
2. To examine the certificates presented by the bondholders for the purpose of noting whether or not all the information required thereon has been furnished. Certificates should not be accepted until the bondholder has filled them in completely. Corporations presenting certificates for individual, fiduciary and partnership owners must disclose the actual owner's name on the certificate.
3. To reject ownership certificates presented by resident bondholders in connection with non-tax-free bonds and with bonds issued by individuals and partnerships, since certificates are required to be executed by such bondholders only in connection with corporate tax-free issues.
4. To forward properly prepared ownership certificates with coupons through the regular channels to the debtor corporations.

Duties of Debtor Corporations:

1. To examine ownership certificates and to return incomplete certificates to paying agents or bondholders to have the missing information supplied.
2. To separate all completely executed ownership certificates, which have first been divided according to bond issue, into three classes:
 - (a) Certificates with amounts of interest on the first line;
 - (b) Certificates with amounts on the second line;
 - (c) Certificates with amounts on the third line.
3. To determine the number of certificates having the amount of interest reported on the first line thereof and enter such number in the space on monthly withholding return (Form 1012), entitled "Number of Forms 1000 transmitted on which exemption is claimed".
4. To list on Form 1012 all certificates for each issue having the amount of interest entered on the second line thereof. (The name and address of the bond owner and the amount of interest paid are required to be shown.) To enter the total amount of interest on all certificates of this class on line 1 of the summary block on Form 1012, in the column entitled "Interest Paid". On this amount of interest, 1½ per cent should be entered in the column entitled "Tax Withheld".
5. To list on Form 1012 all certificates for each issue having the amount of interest entered on the third line thereof. (The name and address of the bond owner and the amount of interest paid are required to be shown.) To enter the total amount of interest on all certificates of this class on line 2 of the summary block on Form 1012, in the column entitled "Interest Paid". On this interest, 2 per cent tax should be entered in the column "Tax Withheld".
6. To prepare ownership certificates (Form 1000) for all interest payments made in connection with registered bonds except to corporate owners. The amount of interest should be listed on the third line of the certificates, and these certificates listed as all other certificates with interest entered on the third line.
7. To indicate clearly on each monthly return (Form 1012) the name or names of the issues for which ownership certificates apply. Where certificates for more than one issue are included on one return, the certificates should be listed according to issue and captioned with the name of the issue.
8. To prepare a withholding return for each month during the year for which ownership certificates are received and to forward the returns when prepared to the Commissioner of Internal Revenue, Sorting Section, Washington, D.C.
9. To use care at the close of the year in listing ownership certificates from coupons paid during that year on monthly withholding returns for the same year. Ownership certificates paid in December of one year are quite often received by the debtor corporation in January of the following year. Such certificates should always be listed on a monthly return marked for December.
10. To prepare an annual withholding return (Form 1013) on which will be shown the amount of tax withheld according to the summary blocks on the several monthly returns (Form 1012) previously prepared and to file it, on or before March 15th, with the collector of internal revenue for the district in which the debtor corporation is located.
11. To pay the tax shown to be due on the annual return to the collector of internal revenue on or before June 15th.

ANNEX II.**PROCEDURE RELATING TO OWNERSHIP CERTIFICATES (FORM 1001) OF NON-RESIDENT ALIEN INDIVIDUALS, FIDUCIARIES, PARTNERSHIPS AND CORPORATIONS, AND MONTHLY AND ANNUAL WITHHOLDING RETURNS (FORMS 1012 AND 1013).***Duties of Bondholders:*

1. To procure and fill in ownership certificate (Form 1001—green form) when presenting coupons from corporate bonds to the debtor corporation, bank or other paying agent for payment or collection, whether or not such bonds contain a tax-free covenant.
2. To use care in entering the correct amount of the interest received (face value of the coupon) in the proper line on the ownership certificate (Form 1001). If the owner of the bonds is a non-resident alien individual, fiduciary or partnership the amount should be entered on the first line of the certificate; if a corporation, it should be on the second line of the certificate and, if the owner is unknown, on the third line. Each line is divided into three columns. Interest from bonds on which the corporation agrees to pay a tax for the bondholder in an amount in excess of 2 per cent should be entered in the first column. This means that the corporation will pay for the individual 2 per cent of the interest shown on the certificate and that nothing will be deducted from the interest. Interest from bonds on which the corporation agrees to pay a tax for the bondholder in an amount not in excess of 2 per cent should be entered in the second column. This means that tax will be deducted at the rates shown therein and that the corporation will also pay 2 per cent of the amount of interest shown on the certificate. Interest from bonds on which the corporation does not agree to pay any tax should be entered in the third column. This means that the bonds are not tax-free and that tax will be deducted at the rates shown therein and that the corporation will not pay any tax on such interest other than that deducted.
3. To submit the ownership certificate with the coupon to the bank or other paying agent so that the debtor corporation may receive the coupon and the certificate at the same time.
4. To prepare exemption certificates (Form 1002—applicable to non-resident alien individuals and fiduciaries only) if the alien individual and fiduciary finds, at the close of the year, that his total income, including dividends from sources within the United States, does not exceed \$10,000, and, exclusive of such dividends, is less than the personal exemption of \$1,500, and the credit for dependents if a resident of Canada or Mexico. The form 1002 should be filed with the corporation which issued the bonds at any time after the close of the calendar year; but not later than May 1st of the succeeding year.
5. To prepare income-tax returns, provided a non-resident alien bondholder desires to claim a refund in those cases where an exemption certificate (Form 1002) is not applicable, or in case the tax has not been fully paid at the source. The income-tax returns should include all interest received from tax-free covenant bonds and non-tax-free bonds and the tax should be computed on same as on all other types of income. After tax is computed, a credit should be claimed against the tax in an amount equal to that paid by the corporation, plus that actually deducted from the interest as a result of the ownership certificates submitted.

Duties of Banks and other Paying Agents:

1. To require that ownership certificates be submitted with all coupons detached from bonds of domestic and resident corporations.
2. To examine the certificates presented by the bondholders for the purpose of noting whether or not all the information required thereon has been furnished. Certificates should not be accepted unless the bondholder has filled them in completely.
3. To deduct the tax required as indicated by ownership certificate using rate applicable to the block in which the amount of interest has been entered.
4. To forward properly prepared ownership certificates with coupons through the regular banking channels to the debtor corporations.

Duties of Debtor Corporations:

1. To examine ownership certificates and to return incomplete certificates to the paying agent or the bondholder to have the missing information supplied.
2. To separate all completely executed ownership certificates, which have first been divided according to bond issue, into five classes according to tax rate:
 - (a) Certificates from which no tax has been deducted but on which the corporation will pay 2 per cent of the interest shown thereon;
 - (b) Certificates from which tax has been deducted at the rate of 3 per cent and in addition to which 2 per cent will be paid by the debtor corporation;
 - (c) Certificates from which tax has been deducted at the rate of 10 per cent and in addition to which 2 per cent will be paid by the debtor corporation;
 - (d) Certificates on which tax has been deducted at the rate of 5 per cent and nothing is to be paid by the debtor corporation;
 - (e) Certificates on which tax has been deducted and nothing is to be paid by the debtor corporation.
3. To list all ownership certificates (Form 1001) according to the several groups on monthly withholding returns (Form 1012). In those cases where tax was deducted from the interest, the amount so deducted must be entered in the column on Form 1012 entitled "Owner of Bonds" and the amount to be paid by the debtor corporation must be shown in the column entitled "Debtor Corporation", both of those columns being under the heading of "Amount of Tax Withheld".
4. To enter in the summary block on monthly return (Form 1012) the interest totals and totals of tax withheld according to the rate of tax and also a grand total of the separate sub-totals. In paragraph 2 above, the certificates were divided into five classes for purposes of listing. Adherence to these classes for purpose of entering totals in summary block will prove helpful. The total interest paid and tax withheld from certificates grouped in class (a) of paragraph 2 above should be entered on the second line of summary block; the total interest paid and tax withheld from certificates grouped in classes (b) and (d) should be entered in the third line of the summary block; and the total interest paid and tax withheld from certificates grouped in classes (c) and (e) should be entered in the fourth line of the summary block.
5. To mark clearly each monthly return (Form 1012) as to name of bond and the status of the bond with respect to (a) tax-free limited to 2 per cent, (b) tax-free not limited to 2 per cent, and (c) not tax-free, in the spaces provided therefor.

6. To file annual withholding return (Form 1013), upon which will be shown a summary of all monthly withholding returns (Form 1012), with the collector of internal revenue, on or before March 15th of the following year.

7. To examine exemption certificates (Form 1002) received from non-resident alien individuals and fiduciaries and to enter the information in the spaces on the lower portion of these forms and to make notations on retained copies of Forms 1012 as to the certificates received before they are forwarded to the Commissioner of Internal Revenue, Sorting Section, Washington, D.C., with letter of transmittal. After they have been examined by the Bureau, the debtor corporation will be notified in order that the amount of tax deducted from the non-resident alien individual may be refunded to him ; or, in the case of tax assumed by the debtor corporation, abated.

8. To pay, on or before June 15th, to the collector of internal revenue the tax shown to be due on Form 1013, less the amount included in letter from the Commissioner approving Forms 1002.

9. To forward exemption certificates (Form 1002) received subsequent to the payment of the tax directly to the Commissioner of Internal Revenue, Sorting Section, Washington, D.C., for adjustment.

10. To retain copies of monthly and annual withholding returns prepared to report tax to be paid at source.

11. To procure from collectors of internal revenue all blank forms necessary to comply with the above procedure.

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