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# INCOME TAX REFORM: THE VENEZUELAN EXPERIENCE †

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## FOREWORD

The research for and writing of the article which follows was done by Enrique F. Gittes at my request and with the financial assistance of the Harvard Law School International Tax Program. There were several reasons for the undertaking. The Shoup Mission Report (see footnote 1 in the article) on the Venezuelan tax system was by mid-1966 about seven years old, so that sufficient time had passed to inquire into its impact. At the same time the Government of Venezuela was actively engaged in proposing major changes in Venezuelan tax law, a number of which were similar to suggestions in the Shoup Report. Also, Mr. Gittes, a June 1965 graduate of the Harvard Law School with one year of New York law practice in Latin American legal problems, was about to depart for Chile as a member of a four-man tax reform team constituting the AID-financed Harvard-Chile Tax Project. In order to aquaint himself more thoroughly with recent Venezuelan tax legislation — he was already bilingual — Mr. Gittes did research in New York and Cambridge to trace every tax law which had been adopted in Venezuela subsequent to the Shoup Report. After pulling the substantive changes in tax law together, he went to Venezuela for just under two weeks to talk with people there, to obtain the latest information about proposals under consideration, and to observe the tax administration. The Director of the Tax Administration in Venezeula, Dr. Francisco García Hércules, a man with considerable experience in tax administration, had been a recent student of mine in the International Tax Program and thought highly of the idea of the study.

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†The author gratefully acknowledges the assistance of Roger Thomas, Research Associate of the Harvard Law School International Tax Program, who reviewed and contributed substantially to the manuscript. Preparation of the article was aided greatly by the cooperation of officials of the Venezuelan income tax administration, particularly Dr. Francisco García Hércules, Director.

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The first draft of the study was prepared on the basis of the June 1966 research and a July 1966 copy of the proposed changes. As it became clearer in the fall of 1966 that a new law was indeed likely to be adopted, it was decided to await passage of the law, so that the final version of the article could report on the actual law rather than a proposed one. In early 1967 the final version of the law as adopted was forwarded to Mr. Gittes in Chile, where he was able, with the acknowledged Cambridge-based assistance of Roger Thomas, to write and revise the article which follows.

The Shoup Report is still considered a principal reference work on the tax problems of less developed countries. It was published in English and in Spanish in 1959 on the basis of research done during the summer of 1958, with updating to June 1959. The Report was done at the request of the Government of Venezuela after the January 1958 revolution which overthrew the dictator Perez Jimenez. The draft of the report was given to the Government in August 1958, many months before the election which was to replace the interim Presidential Junta with a duly elected President. Publication occurred after the election.

It is difficult to measure the impact of the Report, but it is certain that Professor Shoup's insistence that the Report be published and that it be published in Spanish as well as English was crucial to the Report's having substantial impact. The Report has been and is probably still being used in Venezuelan universities. As Mr. Gittes' article shows, a number of the Report's suggestions were ultimately followed; and a number were not. The role of the Report in stimulating interest in tax structure reform and in identifying problem areas ought not be underestimated.

Moreover, the impact of the Report in other countries ought not to go unnoticed. The Report received wide distribution in Latin America and no doubt had a bearing on the Conferences on Tax Administration (Buenos Aires 1961) and Tax Policy (Santiago 1962), as well as on the formulation of the tax planks of the Alliance for Progress. Reforms which have already taken place in such countries as Mexico and El Salvador and are in progress in such countries as Brazil and Chile parallel many of the Report's suggestions with respect to income taxation. Finally, the Report continues to serve as a model in the preparation of fiscal surveys for other countries.

The American reader who is unfamiliar with foreign tax systems will find the present article helpful in thinking about basic features of an income tax. For example, the entire problem of the taxation of corporations in relation to taxation of their shareholders is one which is dealt with in recent Venezuelan changes. This problem is also one of the major ones faced in the recent report in Canada of the Royal Commission on Taxation (the Carter Report). Other basic problem areas dealt with in the Venezuelan changes are rate structures, personal exemptions, investment incentives, and tax administration.

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The Shoup Mission Report on the Fiscal System of Venezuela[1] was the product of a study carried out at the request of the Venezuelan Government during the summer of 1958 and subsequently updated to June, 1959. Although more than seven years had passed, the Report's detailed description and analysis of the Venezuelan income tax structure remained essentially accurate until January 1, 1967, when a new income tax law became effective.[2]

The 1967 law, actually passed on December 9, 1966, represents the first implementation of many of the recommendations made by the Report, including such basic structural reforms as the taxation of dividends and the elimination of schedular taxes, that is, different flat rates of tax applicable to different types of income. Other less important recommendations, both substantive and administrative, could not be implemented earlier because they were contingent in varying degrees upon the introduction of these basic reforms.

Enactment of the new law makes this an opportune time to review income tax developments since the publication of the Report, not only to update it, but also to indicate the extent to which the Report's recommendations have affected Venezuelan income tax legislation. No attempt will be made to discuss in detail all of the suggestions included in the Report. Discussion will center primarily upon the Report's most important recommendations and how they have fared as a result

1. C. SHOUP, ET AL, THE FISCAL SYSTEM OF VENEZUELA (1959). Hereinafter referred to in the text as the Report and cited as REPORT. Professor Shoup of Columbia University was Director of the Commission to Study the Fiscal System of Venezuela. Other members of the Commission were John F. Due of Illinois University, Lyle C. Fitch of the New York City Government, Donald MacDougal of Oxford University, and Oliver Oldman and Stanley S. Surrey of the Harvard Law School.

A brief summary of the Report is not easy to give; the first twenty of its 491 pages are devoted to a summary. The briefest highlighting of its conclusions and recommendations may help to give perspective to the present discussion, although it will hardly do justice to the task performed by the study group.

The Report noted four striking features of the Venezuelan revenue system:

(1) the national government receives practically all of the nation's tax revenues;
(2) taxes on petroleum companies by far produce the major portion of the national tax revenues;
(3) indirect taxation, especially custom duties, produce the major portion of the remaining national tax revenues;
(4) the tax system seemed "erratically progressive." REPORT at 2

The major tax recommendations include: "A reform of the structure of the income tax, with certain changes in administrative procedure; a revision of custom duties and customs administration; repeal of the "cinco por mil" tax; an increase in the tax on gasoline; and a strengthening of the municipal real estate tax in urban areas." REPORT at 1

2. Income Tax Law of Dec. 9, 1966, G.O. No. 1069 *Extraordinario* of Dec. 23, 1966 (hereinafter 1967 ITL).

of subsequent legislative action. As in the Report, attention will be directed first to the most significant substantive changes, then to important administrative reforms. The reader who wishes a more detailed understanding of the over-all impact of the Report should refer to the Report itself.

Indirect taxes and customs duties will not be discussed in detail. Generally speaking, it can be said that no substantial changes have taken place during the years since publication of the Report. The trend toward protective customs duties, noted in the Report, has continued; many customs tariffs have been raised to prohibitive rates, many imports have been placed in categories requiring special import licenses, and important increases in exonerations have been granted to Venezuelan importers. As a result, total collections of customs fees and consular duties were less in 1965 than in 1959, and the relative importance of customs duties to total fiscal revenues has been noticeably reduced. At the time some customs tariffs were being raised for protective reasons, the list of restricted goods was being narrowed, thus increasing free market imports and the demand for foreign exchange. Revenues from the government's foreign exchange activities have consequently increased to about Bs. 975 millions in 1963. (One bolívar = about 30 U.S. cents). Exchange control regulations and differential exchange rates, however, were eliminated in January of 1964, reducing government revenues by approximately Bs. 770 million. This loss was somewhat counterbalanced in the same year by increasing income taxes on the oil and iron companies, whose income after the first quarter of 1964 was to be calculated at the rate of Bs. 4.40 per U.S. dollar, a substantial change from prior rates of Bs. 3.09 and Bs. 3.33 for oil and iron companies, respectively.

It should be borne in mind throughout the following discussion that the income tax now enjoys much greater importance than it did at the time the Report was written. The decrease in the indirect-direct tax mix from an estimated 70.2% in 1959 to 57.5% in 1964, and to 54.1% in 1966, has markedly reduced the regressive potential of the system as a whole.

## I. The Income Tax Law

At the time the Report was drafted, the income tax system was made up of nine schedular taxes applied at various flat rates to particular types of income, a complementary tax applied at progressive rates to income from all sources, and a special additional tax imposed upon recipients of income from oil and mining activities. The complementary tax also applied to corporate income and dividends paid by corporations which were exempt from tax.

### *A. Schedular Taxes*

Aside from various quantitative changes in the rates and exemptions under the schedules, no qualitative changes were made in the schedular system until the 1967 law. The widely differing treatment accorded income depending upon its schedular classification persisted despite the Report's conclusion that such differential treatment was generally unjustified and should be eliminated. Existing differences in treatment were further aggravated by the moderate increase in schedular tax rates and the substantial increase in complementary tax rates carried out after the Report was published. These increases made the consequences of being classified into one or another schedule much more serious than was the case at the time of the Report. By the time the new law was enacted, schedular rates had reached the following levels:

| *Schedule* | *Type of Income* | *Rate* |
|---|---|---|
| 1 | Rents from real property | 5% |
| 2 | Interest and royalties | 6% |
| 3 | Business profits | 5% |
| 4 | Oil and mining profits | 2½% |
| 5 | Agricultural profits | 4% |
| 6 | Profits from non-commercial professions | 4% |
| 7 | Salaries and wages | 3% |
| 8 | Gains from sales of real property | 6% |
| 9 | Lottery prizes and other chance winnings | 30% |

The rates of schedules 1, 2, 3, 5, 6 and 8 were doubled and that of schedule 7 tripled to the above levels in 1961.[3] The 2½% rate applicable to oil and mining profits was not changed, probably because such income was already being taxed at a very high effective rate as a result of the 1958 increase in complementary tax rates.[4]

The 1967 law has finally eliminated the schedular taxes in favor of a system of progressive rates which is fully described below. Some

3. Decree 580, G.O. No. 26,592 of July 1, 1961 (hereinafter Decree 580).
4. Decree 476, of Dec. 19, 1958 (hereinafter Decree 476). *See* Appendix C of the REPORT.

proportional rates have been retained, however. Income received by foreigners from wages and salaries and from professions — taxed respectively at proportional rates of 6% and 12% in 1958 and 10% and 15% in 1961[5] — is now subject to flat rates of 12% and 18%.[6] The rate applicable to fortuitous gains (schedule 9) was doubled to 20% in 1958 and raised again to 30% in 1961.[7] However, this latter revision provided that winnings from on-track betting would be taxed at only 15%. These same rates of 15% and 30% have been retained in the new tax law.[8]

### *B. Complementary Tax*

By far the most important structural modifications enacted before 1967 were those relating to the progressive complementary tax. As indicated in Appendix C of the Report, the complementary tax rates were increased in 1958, from a minimum of 1.5% and a maximum of 26% to a minimum of 2% and a maximum of 45%. At the same time, the first bracket was reduced in size, as recommended by the Report, from Bs. 0- 10,000 to Bs. 0-8,000 (further reduced in real terms by subsequent devaluation) but the total number of brackets, instead of being reduced as recommended, was increased from 29 to 30.

A more significant structural change in the complementary tax was brought about in 1961 by the introduction of a separate scale of rates for the income of corporations and foreign taxable entities.[9] One of the Report's strongest recommendations was that there be separate rates applicable to corporate income and personal income, in order to provide greater flexibility in the formulation of tax policy, particularly if it became necessary to increase total tax revenues.

The Report suggested a corporate tax with a rate schedule consisting of two or three brackets and rates commencing at a level somewhat higher than the tax on individuals having the same income. By way of example, the Report outlined a structure with a 10% tax on income up to Bs. 50,000 or Bs. 100,000, a 20% tax on income in

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5. Decree 580, and Decree 476.
6. 1967 ITL, art. 59, *para. segundo.*
7. Income Tax Law Reform of Feb. 13, 1961, G.O. No. 669 *Extraordinario* of Feb. 17, 1961 (hereinafter 1961 ITL).
8. 1967 ITL, art. 76. It may be noted that the REPORT excepted the flat rate on chance winnings from its recommendation to eliminate the schedules.
9. Decree 580.

excess of that amount up to Bs. 10,000,000, and a tax at whatever top rate was desired on income in excess of Bs. 10,000,000. The top rate would presumably be designed to maintain or increase tax revenues from the oil companies. This suggestion of a simplified bracket structure was not adopted however. The structure enacted in 1961 and in effect until 1967 was as follows:

| *Net Income* | | | *Tax Rate* |
|---|---|---|---|
| Bs. 0.01 | to | Bs. 100,000 | 10% |
| 100,000.01 | to | 1,400,000 | 20% |
| 1,400,000.01 | to | 3,800,000 | 25% |
| 3,800,000.01 | to | 6,400,000 | 30% |
| 6,400,000.01 | to | 10,000,000 | 35% |
| 10,000,000.01 | to | 20,000,000 | 40% |
| 20,000,000.01 | to | 28,000,000 | 42.5% |
| 28,000,000.01 | and over | | 45% |

### C. *Additional Tax on Oil and Mining Income*

Since 1948 income from oil and mining activities has been subject to a special income tax in addition to the schedular and complementary taxes.[10] Although this additional tax is also imposed upon taxpayers who receive royalties from oil and mining activities, the principal taxpayers subject to the tax are the oil and mining enterprises. An additional 50% levy is imposed upon the amount by which the net income of such enterprises after taxes (except the additional tax) exceeds the total amount of such taxes paid. Thus, prior to the 1967 law, if an enterprise's net income after payment of schedular, complementary and other taxes (excluding the additional tax) exceeded the total of such taxes paid, then this excess was subject to the additional 50% tax. In this manner, the government in effect guaranteed itself tax revenues equaling one half of the oil and mining industry's net income before taxes.

As a result of the 1958 increase in the maximum complementary tax rate from 26% to 45%, the additional tax was rendered virtually ineffective. Even under the prior 26% maximum complementary tax rate, a number of oil production companies were not subject to the additional tax because the total taxes which they paid, notably the exploration and production taxes, already equaled 50% or more of net after-tax income. The Report pointed out that a small increase in the complementary tax would be offset by a corresponding reduc-

10. 1961 ITL, arts. 43-47; 1967 ITL, arts. 77-80.

tion in the additional tax payable by the three largest companies in Venezuela and that a slightly greater increase would raise total income tax payments by these companies above the level of 50% of operating income and thus completely eliminate any additional tax liability.

As a result of the substantial increase in the top rates of the complementary tax as well as the increase at all levels brought about by the subsequent reduction in the number of brackets of the corporate tax from 30 to 8, only about 4 small oil companies and 2 large mining companies remained subject to the additional tax of the more than 50 companies which had been subject to it at the time the Report was published.[11] In fact, the government's average share of oil companies' operating income, far from 50%, was raised to between 60% and 65% by the rate change and currently may be as high as 67%.[12]

Even enough the additional income tax has apparently outlived its usefulness and now produces only minor revenues, the new income tax law has incorporated the additional tax without modification.[13]

### *D. Rate Structures of the 1967 Law*

Although it retains the additional tax, the 1967 law has replaced the complementary and corporate rates and the various proportional schedular taxes. The 1967 law contains three distinct progressive/rate structures labeled simply "A", "B", and "C" and respectively applicable to: (A) commercial and business income; (B) oil and mining income, and (C) salaries, wages, dividends and other individual income not taxed under (A) or (B).[14] The rate structures are as follows:

*Rate A*

| | *Income Brackets* | *Tax Rate* |
|---|---|---|
| From | 0.01 — 100,000.00 Bs. | 15% |
| | 100,000.01 — 1,400,000.00 | 25% |

11. Unsupported estimate of the Tax Administration office responsible for oil and mining income.

12. *Id.* These estimates are not supported by data. A government study of the impact of the complementary rate changes was begun, but was abandoned. It was felt that it would be impossible to determine what portions of increased tax revenues were attributable to the devaluation of the currency, to the increased economic activity, or to the rate increase itself.

13. 1967 ITL, arts. 77-80.

14. In the committee report accompanying the bill to Congress *(Exposición de Motivos)*, passing mention was made of the fact that foreign experts had recommended eliminating the schedular system for reasons which are enumerated and which parallel those listed in the REPORT.

| | | |
|---|---|---|
| | 1,400,000.01 — 3,800,000.00 | 30% |
| | 3,800,000.01 — 6,400,000.00 | 35% |
| | 6,400,000.01 — 10,000,000.00 | 40% |
| | 10,000,000.01 — 20,000,000.00 | 45% |
| | 20,000,000.01 — 28,000,000.00 | 47.5% |
| over | 28,000,000.00 | 50% |

*Rate B*

| | *Income Brackets* | *Tax Rate* |
|---|---|---|
| From | 0.01 — 100,000.00 Bs. | 20% |
| | 100,000.01 — 1,400,000.00 | 25% |
| | 1,400,000.01 — 3,800,000.00 | 28.5% |
| | 3,800,000.01 — 6,400,000.00 | 33.5% |
| | 6,400,000.01 — 10,000,000.00 | 39% |
| | 10,000,000.01 — 20,000,000.00 | 44.5% |
| | 20,000,000.01 — 28,000,000.00 | 47.5% |
| over | 28,000,000.01 | 52% |

*Rate C*

| | *Income Brackets* | *Tax Rate* |
|---|---|---|
| From | 0.01 — 20,000.00 Bs. | 4.5% |
| | 20,000.01 — 30,000.00 | 7.25% |
| | 30,000.01 — 50,000.00 | 9.5% |
| | 50,000.01 — 80,000.00 | 11% |
| | 80,000.01 — 120,000.00 | 12.5% |
| | 120,000.01 — 200,000.00 | 14.5% |
| | 200,000.01 — 300,000.00 | 16.5% |
| | 300,000.01 — 500,000.00 | 19% |
| | 500,000.01 — 800,000.00 | 22% |
| | 800,000.01 — 1,200,000.00 | 25% |
| | 1,200,000.01 — 2,000,000.00 | 28% |
| | 2,000,000.01 — 3,000,000.00 | 31% |
| | 3,000,000.01 — 5,000,000.00 | 34% |
| | 5,000,000.01 — 8,000,000.00 | 39% |
| over | 8,000,000.00 | 45% |

1. Rate Structure "A"

Rate structure "A" is the previous corporate rate structure increased by 5% across the board, reflecting the absorption of the 5% schedular rate.[15] Consequently, rates range from 15% on income of zero to

15. The rate structure originally presented to Congress not only absorbed the 5% schedular rate, but also effectively increased rates in the higher brackets. The proposed rates are shown below for comparison. It will be noted that the proposed rate structure had two apparent advantages. It somewhat smoothed the progression in the first brackets by introducing a bracket between Bs. 100,000 and Bs. 500,000;

Bs. 100,000 up to 50% on income in excess of Bs. 28,000,000. These rates are applicable to the income of all corporations, unincorporated businesses and *comunidades* (similar to estates and trusts) other than those engaged in oil and mining activities.[16] Expressly excepted are "non-commercial" professional partnerships, whose income is taxed at "C" rates to the individual partners in proportion to their interests in the partnership.[17] This latter provision, of considerable importance to professional partnerships, was not in the original bill submitted to Congress. Also subject to "A" rates is the income which natural persons derive from commercial and industrial activities, from farming, animal husbandry, fishing, forestry, private schools and sales of real property.[18] Royalties and related income from oil and mining are explicitly excluded from rate "A" and assigned to rate "B".[19] A similar exclusion may be needed for dividends received by natural persons. In the absence of such an exclusion, it now appears that dividends are taxable under both rate "A" and rate "C".[20]

To avoid discrimination between labor and capital income in the lower brackets and to alleviate the thorny problem of classifying the "mixed" income of most small business ventures, the first Bs. 80,000 of a person's "A"-type income is taxed under the lower labor rate "C" if total net income otherwise subject to rate "A" does not exceed Bs. 120,000.[21]

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also it made all brackets more susceptible of statistical use by rounding them off.

| | *Proposed Rate A Income Brackets* | *Rate* |
|---|---|---|
| From | 0.01 – 100,000.00 Bs. | 15% |
| | 100,000.01 – 500,000.00 | 25.5% |
| | 500,000.01 – 1,000,000.00 | 32% |
| | 1,000,000.01 – 2,000,000.00 | 38% |
| | 2,000,000.01 – 5,000,000.00 | 43% |
| | 5,000,000.01 – 10,000,000.00 | 48% |
| | 10,000,000.01 – 30,000,000.00 | 52% |
| | 30,000,000.01 | 55% |

16. 1967 ITL, art. 4.
17. 1967 ITL, art. 4, *para. único.*
18. 1967 ITL, art. 5.
19. 1967 ITL, art. 7.
20. 1967 ITL, art. 8 makes clear that aside from foreign entities, the only rate "A" taxpayers to include dividends in taxable income are natural persons. As taxation of dividends was not contemplated in the original bill presented to Congress, but was added later, it seems that this failure to limit dividends to taxable income under rate "C" was an oversight.
21. 1967 ITL, art. 5, *para. unico.* Note that a rise in income of one Bolívar over Bs. 120,000 will increase the tax due by Bs. 1,575.

In addition, a *comunidad* or unincorporated business whose total net income subject to rate "A" does not exceed Bs. 180,000 receives a 60% credit against the tax due on the first Bs. 100,000 of income, and a 70% credit against the tax due on the income between Bs. 100,000 and Bs. 180,000.[22] Consequently, the only taxpayers paying the full "A" rates are corporations, irrespective of the amount of their income, non-incorporated businesses and *comunidades* whose total net income exceeds Bs. 180,000 per year; and natural persons whose type "A" net income exceeds Bs. 120,000.[23] Foreign banks and other credit institutions not domiciled in Venezuela are favored with a

22. 1967 ITL, art. 57, *para. primero.* Note that a one Bolívar increase in income over Bs. 180,000 will raise tax liability by Bs. 23,000. However, those taxpayers coming under the less than Bs. 180,000 category cannot deduct remunerations paid to themselves, their spouses or minor children, Art. 15, para. *tercero.* This applies to partners as well as individual proprietors. Those unincorporated taxpayers whose total income does exceed Bs. 180,000 and thus may not take the deductions described above, are entitled to deduct as remunerations to themselves and family, up to 15% of gross income, Art. 15, *para. tercero* and *segundo,* subject to the limitation of normal salaries paid by similar businesses, Art. 15, *para. cuarto.* It is not clear whether the limit of Bs. 180,000 is total income subject to all rates or only total income subject to rate "A".

23. Under 1967 ITL, Article 6, *comunidades* composed of heirs to an estate are taxed at "A" rates commencing with the fifth year after the opening of the succession. During the first four years, the heirs are taxed at "C" rates on that part of the estate's income which corresponds to their particular interest in the estate. The four years may be extended to ten years if the estate invests in farming, animal husbandry or fishing and has annual net income of less than Bs. 180,000. Operating within this ten-year provision of Article 6, *parágrafo único,* the heirs lose their right to an exclusion of Bs. 30,000 which Article 66 provides to *comuneros* whose income from ordinary farming *comunidades* exceeds Bs. 60,000. Thus, when read together with Article 66. Article 6, *parágrafo único,* turns out to establish a penalty rather than an incentive for certain taxpayers. For example, if a *comunidad* consisting of three heirs engages in farming and income of Bs. 50,000 is earned by each heir, the heirs are allowed to pay tax at "C" rather than "A" rates which means (if this is their only income) that each would pay a tax of Bs. 3,575 instead of Bs. 7,500. However, since they are operating under Article 6, *parágrafo único,* the heirs would lose their right to the Article 66 exclusion of Bs. 30,000 which they would otherwise be entitled to as *comuneros* of an ordinary farming *comunidad,* thus leaving only Bs. 20,000 subject to "A" rates for a total tax liability of only Bs. 3,000. It is possible that heirs operating as *comuneros* under Article 6 would be entitled to share in the single Bs. 30,000 exclusion which Article 66, *parágrafo segundo,* appears to allow the *comunidad* itself; for *parágrafo segundo* expressly denies the exclusion only to *comuneros,* not resolving the question whether such an exclusion continues to be available to an Article 6, *parágrafo único comunidad.* In any event, if the *comunidad* is denied the Article 66 exclusion but reinvests at least 50% of its net income, the heirs will be entitled to an additional investment credit of 20% of their tax liability, under Article 67, *parágrafo quinto.* Thus the tax payable would be reduced from Bs. 3,575 to Bs. 2,860. This 20% investment credit was added to the original bill by Congress.

separate 10% flat rate on net income arising from loans and other credits extended in Venezuela.[24]

To prevent the artificial splitting of businesses in order to avoid the impact of the progressive "A" rate, the bill originally presented to Congress required horizontally integrated companies meeting the test of common control to consolidate their returns. The common control concept was defined as the ownership of more than 50% of the subscribed capital of the businesses in question by the same person or group of persons. For reasons which are not entirely clear, it was thought to be in the best interests of the national economy to allow vertically integrated companies to file separate returns even when common control was clear. In any event, the horizontal consolidation rule did not obtain Congressional approval, and the progressive "A" rates would appear to give strong incentive to artificial splitting for tax purposes.

2. Rate Structure "B"

Rate structure "B" applies to the net income of all persons engaged in the mining or oil industries and related activities such as refining, transport and export of the industries' products.[25] Persons not engaged in such activities are to pay "B" rates on royalties and similar distributions received from persons who are. However, persons other than natural persons are not to include dividends or distributions which they receive as shareholders or partners of "B" rate taxpayers. These provisions raise at least two problems. First, fine characterizations must be made of distributions, designating them as either royalties or dividends. Second, it is not clear from the law whether dividends received by natural persons from "B" rate taxpayers are technically subject to either or both "B" and "C" rate taxes.[26]

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24. 1967 ITL, art. 57, *para. segundo.*

25. 1967 ITL, art. 26. Congress expanded the original bill's list of taxpayers subject to "B" rates to include taxpayers engaged in the purchase for export of oil, minerals and their derivatives.

26. On the one hand, 1967 ITL, Article 44, *parágrafos* 5° and 8° expressly exclude from rate "C" income, any dividends received from rate "B" taxpayers. Also, while Articles 28 and 31 apply "B" rates to "royalties" and "analogous distributions" received by natural persons from rate "B" taxpayers, it would require a rather strained interpretation of these words to make dividends taxable. On the other hand, Article 29, *parágrafo primero,* imposes a withholding requirement on rate "B" taxpayers for dividends paid out to non-resident natural persons. This provision would indicate that such dividends are taxable. Although not quite so clear as in the case of non-residents, it appears that there is also a withholding

The existence of separate tax treatment for mining and oil income is explained by the extraordinarily important position which mining and oil enterprises enjoy in the Venezuelan economy. If mining and oil income were to be taxed as general commercial income under rate schedule "A", tax policy decisions affecting the economy at large would be complicated by the need, in certain instances, to make special provision for the rather unique problems presented by these enterprises.

The "B" rate structure in the original bill was simply the previous corporate rate uniformly increased by 3.5%, which represents a combination of the 2.5% schedular rate plus a 1% real increase. The rate structure finally approved by Congress, however, is not quite so neat either in its relation to previous rates nor to the new "A" rates described above. The first bracket, in particular, raises the rate to 20% from the cumulative 12.50% applicable under prior law and the 13.50% proposed in the bill. The top bracket has also been raised to 52%.[27]

A further interesting modification of the tax structure applicable to oil and mining enterprises was proposed in the bill but did not secure passage. An additional progressive tax, the *complemento selectivo,* was to be applied to net income remaining after application of the "B" rates. This new tax was intended to encourage oil and mining enterprises to increase capital investment, subscribe to government bonds or finance government-approved development projects. If the after "B" tax income amounted to more than 15% of the total value of (1) the taxpayer's net fixed assets, (2) certain investments in the public sector, (3) government-approved investments in the private sector and (4) inventory (hereinafter collectively referred to as

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requirement on dividends paid out to resident natural persons. In any event, some clarification is required in this area.

27. The proposed "B" rates are set out below for comparison:

| | *Proposed Rate B Income Brackets* | *Rate* |
|---|---|---|
| From | 0.01 — 100,000.00 Bs. | 13.50% |
| | 100,000.01 — 1,400,000.00 | |
| | 1,400,000.01 — 3,800,000.00 | 28.50% |
| | 3,800,000.01 — 6,400,000.00 | 33.50% |
| | 6,400,000.01 — 10,000,000.00 | 38.50% |
| | 10,000,000.01 — 20,000,000.00 | 43.50% |
| | 20,000,000.01 — 28,000,000.00 | 46.00% |
| over | 28,000,000.01 | 48.50% |

qualified assets), a tax was to be imposed in accordance with the following rates:

| | | |
|---|---|---|
| Up to and including 15% of qualified assets | .............. | exempt |
| Excess over 15% to 20% of qualified assets | .............. | 10% |
| 20% to 25% | .............. | 12% |
| 25% to 30% | .............. | 14% |
| 30% to 40% | .............. | 19% |
| 40% to 50% | .............. | 26% |
| 50% to 100% | .............. | 38% |

Qualified assets were valued at the average of their book values at the beginning and at the end of the taxable year net of depreciation. Current assets were ignored on the ground that they would generally be offset by current liabilities.

The expectation was that the taxpayer, rather than pay the *complemento selectivo,* would prefer to reduce his ratio of after tax earnings to qualified assets by increasing his investment in qualified assets. Also, the committee report accompanying the bill expressed hope that raising the per-barrel cost to oil producers having a small investment in qualified assets relative to total profits would curtail price-cutting which might endanger the price stability of oil.

The new law adopts a substitute for the *complemento selectivo.* This substitute is directed at oil and mining taxpayers whose profits, following the application of the "B" rate tax reflect a high rate of return. Rather than looking to the ratio of after "B" tax income to qualified assets, however, the new tax looks to the relationship between after "B" tax income and total sales less cost of goods sold. The following table is used to determine what percentage of the after "B" tax income will represent a credit against the amount of the "B" tax.[28]

| After "B" Tax Income As % Of Total Sales Minus Cost Of Goods Sold | % Of After "B" Tax Income To Be Credited |
|---|---|
| 5% or less | 7.70% |
| 10% | 4.65% |
| 15% | 2.30% |
| 20% | 0.70% |
| 25% or more | 0.00% |

28. 1967 ITL, art. 58 b. If the ratio of after "B" tax income to total sales falls between the percentages in the table, the corresponding credit is calculated proportionately.

Thus the taxpayer with high costs is favored with a credit against his "B" rate tax apparently even if the high costs are the result of inefficiency. The taxpayer with an efficient, high-yield investment will bear the full brunt of the "B" rates, with no possibility of avoiding part of the tax by increasing his investment in qualified assets, as was possible under the original proposal. This penalty upon high rates of return seems to be a double-edged sword, for it may well be that the sales price will be fixed by the government for purposes of computing income tax liability. In such an event, the taxpayer who is willing to reduce his rate of return (increasing his credit and reducing his effective "B" rate of tax) by reducing his sales price may find that the government, eager to maintain oil prices, will not recognize his lower prices for tax purposes. Apparently it is hoped that the taxpayers will increase their costs through additional exploration or will be encouraged to exploit relatively low-yield wells and mines, rather than reduce their prices.

In connection with pricing for tax purposes, a provision has been added to the tax law whereby the Executive Branch is empowered to enter into contracts of up to five years duration with taxpayers in oil and mining to fix a method for arriving at minimum prices. Taxpayers entering into such contracts must declare the higher of prices actually obtained or prices calculated through the contract formula.[29] Taxpayers not subject to such contracts may have their prices fixed unilaterally by the Tax Administration.[30]

As noted earlier, the moribund additional tax, which guarantees the government 50% of the pre-tax net income of oil and mining companies, has been retained.[31] The committee report accompanying the 1966 bill to Congress gave no reasons for the retention of this tax which, as noted previously, has had almost no practical application in the past few years. Indeed, the increase in the "B" tax rates would appear to reduce still further the possibility of the additional tax having any effect.

### 3. Rate Structure "C"

The "C" rate structure applies to all income of natural persons except the amounts of their income which are taxed under rate struc-

29. 1967 ITL., art. 41, *para. único.*
30. 1967 ITL, art. 100.
31. 1967 ITL, arts. 77-80.

tures "A" and "B".[32] Most important, dividends have at last become taxable, as discussed below, and are subject to "C" rates.[33]

Rate structure "C" is a modified version of the complementary tax formerly applicable to individuals. The number of brackets is reduced from 30 to 15. Under the "C" rates, the tax on income up to Bs. 30,000 is lower than the combined tax resulting from the previous schedular and complementary rates. Thus, taxes are now lower for more than one half of all individual taxpayers. The taxes on income above Bs. 30,000, however, are substantially higher than the prior combination of schedular and complementary taxes. The amount of real increase over the combined previous rates ranges from .25% to 9%, although because of the consolidation of brackets, the progression of the increase is not constant. The top rate is still 45%, but it is reached at a much lower level of income since brackets above Bs. 8,000,000 have been eliminated, reflecting the fact that no natural persons are actually earning income in excess of Bs. 6,000,000.[34]

4. Computation of Tax

The rate structures as described might appear to result in the substitution of progressive schedular rates for proportional schedular

32. 1967 ITL, art. 43.

33. 1967 ITL, art. 44. *para.* 5°. Further discussion of the taxation of dividends appears below.

34. The existence of higher brackets under previous law was due to the historical development of the complementary rates. The rates were originally designed for all taxpayers including corporations and oil companies. When separate complementary rates were introduced for these latter taxpayers, no adjustment was made in the original rates which continued to be applicable to natural persons. The proposed "C" rates are set out below for comparison:

*Proposed Rate C*

| | *Income Brackets* | | *Rate* |
|---|---|---|---|
| From | 0.01 — | 20,000.00 Bs. | 4.50% |
| | 20,000.01 — | 30,000.00 | 7.50% |
| | 30,000.01 — | 50,000.00 | 10.25% |
| | 50,000.01 — | 80,000.00 | 13.50% |
| | 80,000.01 — | 120,000.00 | 16.00% |
| | 120,000.01 — | 200,000.00 | 19.00% |
| | 200,000.01 — | 300,000.00 | 21.50% |
| | 300,000.01 — | 500,000.00 | 25.00% |
| | 500,000.01 — | 800,000.00 | 27.75% |
| | 800,000.01 — | 1,200,000.00 | 30.50% |
| | 1,200,000.00 — | 2,000,000.00 | 33.75% |
| | 2,000,000.01 — | 3,000,000.00 | 36.25% |
| | 3,000,000.01 — | 5,000,000.00 | 39.50% |
| | 5,000,000.01 — | 8,000,000.00 | 42.50% |
| over | 8,000,000.01 | | 45.00% |

rates since the income source determines which rate is to apply. However, the application of the different rate structures is combined,[35] so that the total tax liability of a taxpayer having income from more than one source will be higher than it would be if each rate structure were applied without reference to the others. The combined computation is done in three steps:

1. "B" rates are applied to type B income;
2. "A" rates are applied to type A income, but at a rate determined by adding type "B" and "A" income;
3. "C" rates are applied to type "C" income, at a rate determined by totaling income of all types.

The sum of the three amounts thus calculated equals tax liability. Natural persons having total net income not in excess of Bs. 12,000 are not taxed.[36]

5. Treatment of Losses

Consistent with the above combination of rate structures, net losses may be applied against income[37] subject to any of the three rate structures, as follows:

1. A loss is first applied against income of the same type as the activity producing the loss, i.e., an "A" type loss is first used to offset any "A" type income.
2. A net loss of the "A" type may then be offset first against "B" type income and then any remaining loss against "C" type. Similarly, a net "B" loss is offset first against "A", then against "C", and a net "C" loss first against "A" and then against "B".
3. The three-year net loss carry forward is applied in the order provided in the preceding steps.[38]

### *E. Exemptions, Credits, and Investment Incentives*

Exemptions under the prior schedular system did not take into

35. 1967 ITL, art. 60.

36. 1967 ITL, art. 61. It is not clear whether this provision refers to Bs. 12,000 of "C" source net income or Bs. 12,000 total net income from all sources. In any event, the familiar problem of the sudden jump in tax liability upon earning one Bolívar more than Bs. 12,000 has been eliminated by providing single wage earners with sufficient credits under Article 73 to absorb the "C" rate tax on income up to Bs. 12,400, without considering dependency credits. "A" rate taxpayers would be in a similar situation since they pay "C" rates on the first Bs. 80,000 if total income does not exceed Bs. 120,000, art. 5, *parágrafo único*.

37. 1967 ITL, art. 63.

38. 1967 ITL, art. 64.

account the number of a taxpayer's dependents, and no attempt was made to follow the Report's suggestion to alter this situation. Personal exemptions were, however, lowered as recommended, both as a result of changes in the law and as a result of currency devaluation. Thus at the same time rates were increased, the basic exemptions for schedules 1, 2, 3, 4, 6 and 8 were reduced from Bs. 12,000 to Bs. 11,400; continued was the characteristic that the taxpayer lost the exemption if the level of his total income from these schedules exceeded a certain sum, but the level at which the exemption vanished was lowered from Bs. 19,200 to Bs. 11,400.[39] The exemption under schedule 7 was reduced to exempt all wages and salaries when not exceeding Bs. 950 monthly.[40] Subsequently the monthly wages and salaries allowed before the Bs. 950 exemption was lost was raised to Bs. 1600.[41]

The new law[42] grants credits, rather than exemptions, to natural persons and thus does not favor taxpayers in the higher income tax brackets. This approach, one not mentioned by the Shoup Report, gives a credit against tax of Bs. 324 for the taxpayer and an additional Bs. 180 for the spouse and each dependent.[43] Wage and salary earners receive an additional credit of Bs. 234 if they have no income other than salaries and wages and such income does not exceed Bs. 19,800.[44]

The Report recommended that natural persons be allowed a medical expense deduction, but only if such expenses exceeded a certain minimum amount. The bill presented to Congress did not provide for such a deduction. Congress, however, added a medical expense deduction subject to a ceiling or maximum deduction of Bs. 5,000, but

39. Decree 580.

40. *Id.*

41. Decree 723, G.O. No. 26,816 of Apr. 2, 1962.

42. 1967 ITL, arts. 73, 74. Article 40 of the 1961 ITL provided a personal exemption of Bs. 12,000, lowered to Bs. 11,400 by Decree 580, art. 7. Additional exemptions of Bs. 4000 for the taxpayer's spouse, Bs. 3000 per dependent in the immediate family, and Bs. 900 for all other dependents were also granted.

43. 1967 ITL, art. 73. The rather odd relationship of Bs. 324 to Bs. 180 is explained by the fact that the original credit to the taxpayer of Bs. 360 was reduced by Congress but the credit for dependents was not changed.

44. 1967 ITL, art. 74. Congress raised the bill's original figure of Bs. 198. If this Article is interpreted literally, it will certainly give pause to a wage earner who is considering purchasing stock, making a loan, or otherwise making a small investment which would earn him any non-wage income and lose him the additional credit. Also, the wage earner who earns a raise above the Bs. 19,800 limit will suffer an extreme jump in tax liability. E.g., the single wage earner at Bs. 19,800 who receives a Bs. 1000 raise will see his tax liability increase from Bs. 333 to Bs. 648.5.

without a minimum amount which expenses would have to reach before the deduction became effective.[45]

Despite the Report's assertion that the tax system is not a suitable vehicle by which to grant incentives to particular economic activities, no noticeable steps have been taken to eliminate specific incentive exemptions. While it is generally conceded that the original exemption of interest on the first Bs. 10,000 of an individual's savings deposit did not really serve as an incentive to saving, the new law has raised the limit from Bs. 10,000 to Bs. 50,000.[46] On the other hand, although it is believed that the exemption of rentals from new construction was an important factor in the rehabilitation of the construction industry, the new law removes the automatic exemption benefiting that industry. The exemption is now available only upon specific application to the Executive.[47]

Until 1967 there existed an exemption of Bs. 30,000 for income from agriculture, animal husbandry and fishing, so long as net income from such sources did not exceed Bs. 50,000. The new law continues this exemption for net income not exceeding Bs. 60,000 from the above sources.[48] This increased exemption is available only if total receipts from such sources form at least 75% of the taxpayer's total gross income.[49] The previous exemption of interest income up to 6% from mortgages on farms or basic industries was eliminated.[50]

In view of the taxability of dividends under the new law, the Executive has been empowered to exempt dividend income from certain new industries.[51]

Unfortunately both past and present law contains many instances in which the entire exemption can be lost by a minuscule increase in income over a stated amount — a problem clearly pinpointed by the Report.

In the area of general investment incentives, the Report urged the elimination of provisions which reduced rates in the three top brackets

45. 1967 ITL, art. 72.
46. 1967 ITL, art. 2, *para.* 4°.
47. 1967 ITL, art. 3, *para.* 10°.
48. 1967 ITL, art. 66. It is not clear whether the Bs. 60,000 is a net or gross income figure; however, under prior law it was clearly net income. The problems raised by this exemption and its relationship to the Article 6 incentive to *comunidades* has been discussed in note 23 *supra*. One should note the jump in tax liability when income reaches Bs. 60,001.
49. This 75% requirement is new.
50. 1961 ITL, art. 3, *para.* 6°.
51. 1967 ITL, art. 3, *paras.* 4° and 5°.

in the case of reinvested earnings. The Report concluded that such reductions did not really serve as reinvestment incentives since corporations subject to tax in the highest brackets presumably would, in the normal course of their business, retain and invest a sufficient amount of their earnings to qualify for the reduction.

Far from doing away with these rate reductions for reinvested earnings, the separate corporate rate structure and the changes brought about in the complementary tax in 1958 extended the system of rate reductions to taxpayers in all brackets for certain types of reinvestment described below. Furthermore, Congress authorized the Executive to increase the reductions up to 100% "to stimulate the investment and reinvestment of capital in the country".[52]

Through its interpretation of the method by which the amount reinvested annually was calculated, the administration tried in many cases to restrict the broad rate reductions implied by the various legislative enactments. The pertinent provision of the previous Income Tax Law[53] provided that depreciation taken during the year was to be deducted from the cost of new assets representing the investment, leaving an amount which was to serve as the basis of the rate reductions. Neither the law nor the regulations were clear, however, whether the term "depreciation" referred to total depreciation taken during the year or just to that depreciation taken on the new investment. The taxpayers asserted that this provision reasonably contemplated the deduction of only the depreciation taken on the new investment. The tax administration disagreed and required the deduction of all depreciation taken during the year. In many cases, this approach resulted in little or no net investment for the tax year and, consequently, little or no rate reduction even though the taxpayer could point to a sizeable gross investment figure. The new law resolves the problem by siding with the taxpayer and adopting a gross investment concept for purposes of that law's investment credits except when oil and mining investment credits are sought, in which case the law strikes a compromise between net and gross investments.[54] By adopting a gross concept, the new law makes the credit available to a taxpayer who is actually disinvesting in the sense that he is not investing enough each year to replace fixed assets which are being used up.

52. Law of Urgent Economic Measures of June 29, 1961, G.O. No. 26,590 of June 29, 1961, (hereinafter Law of Urgent Economic Measures) art. 1 (5) (b).
53. 1961 ITL, art. 38, *paras. segundo* and *cuarto*.
54. 1967 ITL, art. 67, *para. primero;* art. 68.

The pre-1967 variable investment credit[55] ranged from 10% to 25%, depending on the percentage of net income invested in fixed assets by non-extractive enterprises engaged in industrial production, generation or distribution of electricity, transportation, farming, animal husbandry and fishing. The new law[56] has replaced this system by a flat investment credit of 15% of the amount invested regardless of the percentage of net income invested.[57] Taxpayers engaged in agriculture, animal husbandry or fishing receive an additional 5%, making theirs a 20% credit.

The prior investment credit was denied to taxpayers engaged in canning, packing or packaging products not produced by them and to other taxpayers engaged in activities which were not considered to involve the transformation of raw materials.[58] The new law removes these restrictions in cases where Venezuelan materials or products represent at least 70% of the cost of the finished product.[59]

Taxpayers engaged in oil, mining and related activities are granted a flat 8% investment credit, analogous to the 15% credit described above, but with one very important difference: in calculating the amount of creditable new investment there is deducted not only the depreciation on the new assets themselves, but also 2% of the average value of the fixed assets in the previous year. The credit thus is more nearly a net investment credit and, consequently, has much less value to the taxpayer.[60] An additional 4% credit is granted for certain

55. 1961 ITL, art. 38, *para. cuarto.*

56. The original bill before Congress continued the same system and raised the amount of credit as follows:

| *Investment as % of Net Income* | *Credit* |
|---|---|
| 10% to 20% | 15% |
| 20% to 40% | 20% |
| 40% to 60% | 25% |
| 60% to 80% | 30% |
| 80% to 100% | 35% |

Taxpayers engaged in farming, animal husbandry and fishing were to receive a 5% additional credit. Another provision deleted from the original bill was one by which the Executive could grant the credits to new, development-oriented investments.

57. 1967 ITL, art. 67. As under the 1961 law, taxpayers are not eligible for the credit unless more than 80% of their gross receipts are derived from the activities enumerated. The apparent limitation of the credit under the 1961 law to investment in "equipment" has been deleted, making clear that the credit applies to investments in assets which cannot be considered equipment.

58. 1961 ITL, art. 38, *para. cuarto.*

59. 1967 ITL, art. 67, *para. tercero.* The original bill required only 60%.

60. 1967 ITL, art. 68.

desirable investments such as exploration and secondary recovery of oil.[61] Also, exploration of oil and minerals is encouraged through a 0.25% credit for each 1% increase in gross export income over the average of such income for the two previous years.[62] In no event can the sum of all the above credits taken by oil and mining taxpayers in one year exceed 2% of the taxpayer's total net income; any excess may, however, be carried over for a period of three years.[62]

It should be noted that the credits under the new law reduce the total tax on income while the prior credits were applicable only against the complementary tax. This may mean a real increase in the worth of the credit in some cases.

### *F. Deductions*

The earlier method of limiting deductions for salaries to individual managers or directors was to set a maximum of 8% of gross income, a method termed unworkable by the Report. Nevertheless, the 8% maximum which, it should be noted, was contained in the Regulaitons and consequently could have been changed simply by executive decree, continued in effect until 1967.[64] Thus a given manager's or director's salary was deductible only up to an amount equal to 8% of gross income, while any excess was not deductible[65] and apparently was not included in the recipient's taxable income. The 1967 law simply raises the ceiling to 15% for "A" taxpayers, while "B" taxpayers are to be limited by forthcoming regulations.[66]

The new law contains a more extensive list of deductions than the law of 1961.[67] This does not mean, however, that the new law authorizes more deductions. The 1967 law simply provides an express listing of deductions included in the earlier general allowance for "all

61. *Id.*

62. 1967 ITL, art. 69.

63. 1967 ITL, art. 70.

64. Regulations of Jan. 11, 1956, G.O. No. 479 *Extraordinario* of Feb. 3, 1956, art. 68.

65. Furthermore, the courts interpreted the limitation to apply to the total amount received by an individual irrespective of the fact that a portion of the total was received for professional services rendered apart from the taxpayers duties as a director or manager, as in the case where a company executive receives a retainer as legal counsel in addition to his official remuneration, *Publicidad Bellmor C.A.*, Sentencia No. 325 of the Income Tax Court of Appeals, May 20, 1966.

66. Until new regulations are issued, it may be that "B" taxpayers continue to be governed by the 8% limitation of Article 68 of the 1956 Regulations.

67. *See* the additional deductions contained in 1967 ITL, art. 15 *paras.* 6°, 11°, 12°, 14°, 17°, 18°, 20°.

necessary and normal expenses incurred in the production of income".[68] One clear improvement resulting from the elimination of the schedules is the avoidance of the often arbitrary decisions which were required to allocate expense items, depending upon the schedule into which related income was classified. This aspect of the schedular system drew strong criticism in the Report. It is interesting to note that there persist some differences in the deductions available to taxpayers depending on whether they are under rate "A" or rate "B". For example, commissions to real estate brokers were deductible by both classes of taxpayers in the original bill presented to Congress, but the legislators deleted the deduction for rate "B" taxpayers.[69] Congress similarly eliminated a provision which would have limited a rate "B" taxpayer's deduction for maintenance of rental property to 15% of rental income, yet the limitation continues in effect for rate "A" taxpayers.[70]

Aside from the change introduced in 1958 to the effect that net loss carryovers under schedules 3, 4 and 5 could be used to reduce taxable income subject to the complementary tax, none of the Report's recommendations in the area of deductions has been adopted. These include the introduction of a loss carry-back, the recognition of a capital loss when stock becomes worthless, and the limitation of the medical expense deduction to the amount in excess of a stated sum.

The Report pointed out that since the deduction of charitable contributions was allowed under the complementary tax but not under the additional income tax on oil and mining, any reduction in the complementary tax attributable to a charitable deduction made by an oil or mining enterprise would be offset by a corresponding increase in the additional tax. This anomalous treatment persists but, in view of the vastly reduced importance of the additional tax, the need for a change is not pressing.

### G. *Taxation of Dividends*

One of the principal recommendations of the Shoup Report was that dividends be taxed. The Report described at some length the problems of "double taxation" raised by having corporate profits taxed both to the corporation when earned and to the shareholder when

68. 1961 ITL, art. 12, *para.* 8°.
69. 1967 ITL, art. 15, *para.* 13°.
70. *Compare* 1967 ITL art. 15, *para.* 10° *with* art. 38, *para.* 9°.

distributed as dividends. It compared the equity and administrative aspects of allowing corporations a partial or complete deduction for dividends paid as opposed to granting shareholders a credit for a part or all of the corporate tax paid against the personal tax due on a dividend "grossed up" by the amount of the corporate tax.

In view of the Report's conclusion that dividends should be included in the taxable income of shareholders, it is interesting to note that of the many powers to modify the income tax which were granted the National Executive by the Law of Urgent Economic Measures of 1961, only the power to impose complementary tax rates on dividend income was not utilized.[71] A possible explanation for the failure to use this most important power might be a politically-oriented reluctance to increase the already heavy tax burden on the oil companies, even though the increase would arise indirectly through an additional tax on their shareholders. If this was the Executive's major concern in not acting, it is not clear why oil and mining dividends could not have been exempted from a new tax on dividends generally. The terms of the Executive's grant of power would seem to have allowed such a partial execution, and it can be noted that a similar discrimination was adopted with respect to the general increase in schedular rates, authorized and enacted at the same time, from which oil and mining profits were exempted.

The new tax law bill presented to Congress again spared dividends. Congress, however, introduced a tax on dividends,[72] adopting a credit-to-shareholder approach without the "gross-up" factor.

All dividends except those distributed by taxpayers in oil, mining and related activities and except share dividends are included in gross taxable income subject to the "C" rates on income of natural persons.[73] Dividends received by other than natural persons are not included in gross taxable income unless the recipient is not domiciled in Venezuela,[74] or is engaged in oil, mining and related activities[75]

71. Law of Urgent Economic Measures, art. 1 (5) (i).

72. Throughout this discussion, "dividend" includes analogous distributions and "corporation" includes unincorporated entities such as *comunidades*.

73. 1967 ITL, art. 44, para. 58. *See* discussion in note 26 *supra*, with respect to dividends from oil and mining corporations. Share dividends are given a zero basis for purposes of calculating gains subject to tax at "A" rates, art. 14, *para. quinto*.

74. 1967 ITL, art. 8, *para. único;* art. 29, *para primero*. Unfortunately, the drafting of these two provisions was not coordinated, although presumably they should have the same effect. As a result, while it is clear that rate "B" juridical persons and *comunidades* which receive dividends from the agency or branch

and receives dividends from one who is not so engaged. In the latter case, the recipient must pay a 15% tax unless the dividends are received from an agency or branch of a foreign-organized entity, in which case the agency or branch is required by law to pay the 15% on behalf of its shareholders.[76] Although not apparent from a reading of the law, the Tax Administration, in its instructions to withholding agents, has stated that dividends paid to certain taxpayers subject to arbitrary source allocation rules in the determination of their income are not taxable.[77] These taxpayers, taxed at flat percentages of their Venezuelan gross receipts, include foreign film producers (25%), foreign consignors (25%) and foreign banks (10%).[78]

As noted above, the Congress adopted a credit-to-shareholder approach, but without a "gross-up" provision. Natural persons who have included dividends in their gross taxable income are entitled to a credit equal to an amount calculated by multiplying the dividends received by 40% of the effective rate applicable to the distributing corporation in the previous year.[79] The credit cannot exceed the amount of additional tax resulting from inclusion of dividends in taxable income.[80]

Because dividends are not "grossed-up" by the corresponding amount of corporate tax and because the amount of the credit to the shareholder varies depending on the bracket of the corporation, the operation of this credit yields some strange results. These raise questions of equity both among shareholders in the same bracket and among those in different brackets, as the following examples show.

of a foreign entity do not themselves pay a 15% tax in addition to the 15% withheld by the agency or branch, non-domiciled rate "A" juridical persons and *comunidades* appear to be subject to a 15% dividend tax in addition to the 15% already withheld by the agency or branch.

75. Purchasers of oil and minerals for export are treated under 1967 ITL, Article 8, *parágrafo unico,* as if they were rate "A" taxpayers, and consequently are not subject to this dividend tax.

76. 1967 ITL, art. 49. It is not clear from Article 29, *parágrafo primero,* whether all rate "B" juridical persons and *comunidades* are subject to this 15% tax or whether the tax is limited to non-domiciliaries. Article 29, *parágrafo primero* begins by stating that rate "B" taxpayers, other than natural persons, will not include dividends received as income. However, the paragraph goes on to say that these taxpayers "shall be subject to the payment of the tax rate established in Article 48 . . .". Article 48 provides for a 15% tax on dividends received by non-resident natural persons. *See* discussion in note 26 *supra.*

77. Official Withholding Manual Bulletin No. 1, page 12 (1967).

78. These are taxpayers in 1967 ITL, Articles 20-23 and Article 57, *parágrafo segundo.*

79. 1967 ITL, art. 59, *para. primero.*

80. *Id.*

Corporation A (A) earned Bs. 100,000 in its last tax year and was consequently subject to the 15% first-bracket tax. A's shareholders are entitled to a 6% credit (40% of 15%). Shareholder 1 (SH1), whose personal bracket is 4.5%, and Shareholder 2 (SH2) whose personal bracket is 45%, each receives A dividends of Bs. 1,000. SH1 has a credit of Bs. 45 (due to the limitation) and SH2 has a credit of Bs. 60. If A had paid a 40% effective tax in its last tax year, SH1 would still have his credit of Bs. 45 while SH2 would increase his credit to Bs. 160. On the other hand, if SH1 and SH2 were in the same personal tax bracket of 4.5% and SH1 received dividends from A at 15 % while SH2 received dividends from B (at 40%) both would have the same credit of Bs. 45 but SH2 would theoretically have paid more if the corporate rate is deemed to be a withholding rate to the extent it is creditable, i.e., 40%. Thus, until his personal tax bracket rose to 16%, SH2's credit would not be a sufficient offset to the 40% portion of the corporate tax which could be said to be withholding.

Distributions to shareholders in liquidation or partial liquidation of a corporation are treated as dividends to the extent the amount received exceeds the cost basis of the shares.[81] Also, in certain cases loans made to shareholders are treated as dividends.[82]

Other miscellaneous rules under the taxation of dividends include a flat 30% tax on bearer share dividends unless the holder registers his shares,[83] a 15% tax on dividends paid to non-residents,[84] and a presumed dividend tax levied on agencies, branches and other similar entities related to foreign-organized businesses in the amount of 15% of the net after-tax income of the agency or branch.[85] Dividends taxed under any of these miscellaneous rules are excluded from the rate-combining processes previously described for calculating taxable gains, losses and carryovers.[86]

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81. 1967 ITL, art. 45.
82. 1967 ITL, art. 46.
83. 1967 ITL, art. 47.
84. 1967 ITL, art. 48.
85. 1967 ITL, art. 49. If the foreign-organized entity was established prior to the 1967 law, and deals exclusively in the purchase for export of oil, minerals and their derivatives, its branch or agency or other similar dependency will not be subject to the 15% tax. New entities engaging in this activity must apply for exemption from this tax. Also, income of international business determined by the various arbitrary source allocations in Articles 20 — 23 and 57, *pardgrafo segundo,* are not included in the income base against which the 15% is applied.
86. 1967 ITL, art. 60, *para. unico;* art. 65; art. 50.

### *H. Capital Gains*

Under prior law, capital gains were taxed as ordinary income at various schedular rates depending on classification. The determination of gain on sales of real property by one not engaged in the real estate business, taxable under schedule 8, was subject to two anomalous rules:

1. The gain was prorated over the number of days the real property was held and the portion of gain thus allocable to the holding period prior to January 1, 1943, was not taxed even if the entire gain was due to value accrued since that date; and
2. on the grounds that only true capital gains, and not ordinary income, should be considered upon calculating the gain, a presumed return of 6% per year was added to the cost basis, yet the 6% was never taxed as ordinary income.

The first rule was, by definition, becoming less important every day, but it was a factor unreasonably reducing capital gains income in certain cases. The second rule, while generally recognized to be technically unsound, was justified by some on the ground that it served as a rough substitute for the reduced tax burden which would be represented by an averaging system.

Capital gains continue to be a problem area under the 1967 law. Although the two rules noted above have been eliminated, the Report's recommendation that some provision be made for spreading capital gains income over a period of time to reduce the impact of its being entirely taxable in the year of sale has not been adopted.

Capital gains derived from sales of real property are clearly included in income subject to rate "A" tax.[87] However, it is not clear whether the taxation of capital gains derived by natural persons from the transfer of shares or other personal property is subject to "A" or "C" rates. To include them with "A" type income, one must rely on the provision generally pertaining to commercial activity.[88] This would appear to be a rather weak position were it not for the fact that such capital gains are nowhere mentioned. Furthermore, the provision assigning a zero basis to share dividends certainly points to the taxability of capital gains on their sale and is not limited to share dividends received by other than natural persons.[89]

87. 1967 ITL, Article 5, *parágrafo* 4° for natural persons; Article 8 for others except rate "B" taxpayers; Article 29 for rate "B" taxpayers.
88. 1967 ITL, art. 5, *para.* 1°.
89. 1967 ITL, art. 14, *para. quinto.*

### *I. Accounting Rules*

Several problem areas in the accounting rules were pointed out by the Report, including arbitrary limitations on the use of fiscal or calendar years and cash or accrual bases, unreasonable disallowance of deductions for specific types of reserves such as those for bad debts or accrued severance pay, and lack of control over transactions between companies controlled by the same interests. The recognition of installment-method accounting was partially adopted in the 1958 reform for sales of real estate. The provision, described in appendix C to the Report, provided that in the case of installment sales of real estate under schedule 3 or 8, the taxpayer could include only those installments actually received during his tax year, provided such installments represented more than 40% of his gross income under the respective schedule.

The new income tax is applicable to all "disposable" net income.[90] Disposable income is defined as income received and income accrued except in various cases of installment payments. Thus disposable construction income on jobs lasting more than a year is calculated according to the proportion of the job completed.[91] Income from installment loans is disposable on receipt of the installments and is deemed received immediately if the loan is discounted.[92] Transfers of real property are accounted for both by transferor and transferee in proportion to the amount of the total price which has been effectively paid.[93] Thus the Report's objection to the arbitrary limitations on cash and accrual accounting may have been eliminated.

### *J. The Territoriality Principle*

Little change has occurred in the strict territoriality rule governing income and expenses. The taxpayer must declare only income earned in Venezuela and may deduct only those expenses incurred within the country. A number of exceptions to this rigid territoriality rule have been introduced, but no progress has been made toward a more flexible criterion such as whether or not the income or expense is re-

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90. 1967 ITL, art. 1.
91. 1967 ITL, art. 10.
92. 1967 ITL, art. 1, *para. segundo;* art. 13.
93. 1967 ITL, art. 14, *para. segundo.* For treatment of deductions see Articles 18 and 40.

lated to Venezuelan operations.[94] The 1967 law does provide some help in determining what income and expenses are deemed to be from Venezuelan sources.[95] Also, several arbitrary income allocation rules have been introduced to apply to foreign film producers, international news services, international shippers or carriers and foreign consignors of merchandise for sale in Venezuela.[96] The only instance in which a "Venezuelan operations" allocation rule is adopted is in the additional tax on rate "B" taxpayers.[97]

As to a change-over to a world-wide rule whereby a Venezuelan individual or corporation would be taxed on all income irrespective of its source, the prevailing opinion still seems to be that at present there is not sufficient income being earned abroad by Venezuelans to justify the introduction of such a new concept.

### *K. Treatment of Non-Residents*

Various special rules throughout the new law are applicable to non-residents. A non-resident is defined to be an entity domiciled abroad or a natural person who has not been physically present in Venezuela more than 180 days during either the tax year in question or the immediately preceding tax year.[98]

The Report suggested that if the schedular system were eliminated, non-residents might be generally subject to progressive rates but with a flat rate withholding at the source for such forms of income as salaries, interest, professional fees, royalties, rents and dividends. The new law does not apply progressive rates to non-residents and the total tax must be withheld on payments made to them.[99]

Unlike residents, non-residents are required to declare their income

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94. For example an exception was made for the income of international airlines by applying the arbitrary rule that the sum of 50% of their gross income arising from international flights and 100% of their local travel income is multiplied by 10% to arrive at the airlines' net income. Regulations of Jan. 11, 1956, G.O. No. 479 *Extraordinario* of Feb. 3, 1956, art. 73. These regulations are still in effect although the law for which they were enacted has been repealed. New regulations are needed.

95. 1967 ITL, art. 1, *para. tercero;* art. 14; art. 16; art. 17; art. 34; art. 35, *para. segundo;* art. 39; art. 53.

96. 1967 ITL, arts. 20-23.

97. 1967 ITL, art. 79.

98. 1967 ITL, art. 55. This definition of non-resident natural persons seems limited to cases of wage, salary, professional and dividend income, but presumably would apply, for lack of another definition, to other situations.

99. 1967 ITL, art. 59, *para. segundo;* art. 57, *para. segundo.*

even though it does not exceed Bs. 12,000.[100] Apparently, non-residents are not entitled to the provision which exempts the taxpayer from tax if his total net income does not exceed Bs. 12,000.[101] Flat rate taxes applicable only to non-residents are 12% on wages and salaries,[102] 18% on net professional income,[103] and 15% on dividends.[104] All of these income items are excluded from the rate combination process in arriving at taxable gains, losses and carryovers.[105]

Agencies, branches or other similar dependencies of businesses organized outside of Venezuela, whether or not domiciled in Venezuela, must pay 15% of their after-tax income, deemed to be a withholding on dividends to their shareholders, whether or not dividends are actually paid out.[106] Non-domiciled banks or other credit institutions are subject to a flat 10% tax on income arising from loans or other credit operations.[107]

## II. Inheritance and Gift Taxes

To round out the discussion of direct taxes, brief mention should be made of the developments in inheritance and gift taxes. At the time the Report was written, these taxes were substantially the same as first enacted in 1936 and were badly in need of review. Many needed changes have only now been embodied in a reformed inheritance and gift tax law, passed at the end of December 1966 and effective in January, 1967.[108] Other, less important modifications were

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100. 1967 ITL, art. 81, *para. segundo.* Nor are non-residents eligible for the exemption from filing which can be granted to those whose only income is wages and salaries not exceeding Bs. 48,000 on which tax is withheld. However, this is of no practical importance. In order for withholding to be sufficient to pay the non-resident's 12% tax due on wages and salaries, art. 59, *para. segundo,* the non-resident would have to be earning at a rate far in excess of Bs. 48,000 per year.

101. 1967 ITL, art. 61.

102. 1967 ITL, art. 59, *para. segundo.* Wages and salaries are deemed net income. Art. 54, *para. primero.*

103. 1967 ITL, art. 59, *para. segundo.* Gross professional income less wages, fees and taxes gives the tax base. Art. 54, *para. segundo.*

104. 1967 ITL, art. 48. This seems to contradict the statement in Article 59, *parágrafo segundo,* to the effect that all income of non-resident natural persons other than wages, salaries and professional fees are to be taxed by the corresponding progressive rate scales. This can be explained by the fact that the taxation of dividends was a late addition to the bill and some oversights were made in adjusting the original language of the bill.

105. 1967 ITL, art. 60, *para. unico;* art. 65; art. 50.

106. 1967 ITL, art. 49.

107. 1967 ITL, art. 57, *para. segundo.*

108. *Ley de Impuesto sobre Sucesiones, Donaciones y Demás Ramos Conexos,* G.O. No. 1077 *Extraordinario* of January 17, 1967, (hereinafter 1967 IGT).

put into effect in 1961 as a result of the before-mentioned Law of Urgent Economic Measures.[109]

In 1961 tax rates on inheritances and gifts were increased by roughly 50% up to the Bs. 50,000 level, and were doubled thereafter. If, within a year of the date upon which the tax valuation was made, assets of the estate were sold at a price higher than the tax valuation, tax liability could be reassessed provided there were no intervening factors to explain the price rise.

To discourage the use of bearer shares, the 1961 law also established a tax of 30% of the total capital of any company seeking to convert its stock into bearer shares. However, once the 30% was paid, the shares were excluded from the inheritance and gift tax base. Since the rates in certain cases reached 35% on amounts as low as Bs. 250,000, and could go as high as 55% on larger amounts, a conversion to bearer shares was highly advantageous in certain instances.[110]

Finally, to care for the government's interests, broad investigatory responsibilities were given to notaries, registrars, judges and other public officials obliging them to submit reports and findings to the Tax Administration.

The new 1967 law has eased the 1961 law reassessment procedure by requiring reassessment only when the sales price exceeds assessed value by more than 10%.[111] The 30% tax on the conversion to bearer shares has been raised to 50%.

Among the more important innovations of the new law, most of which were urged by the Report, the following deserve mention. Prior law applied to personal property located outside of Venezuela only if owned by Venezuelans and given to or inherited by persons domiciled in Venezuela. The new law eliminates the requirement of Venezuelan ownership of such property.[112] Furthermore, if such property is taxed abroad, a tax credit of up to 75%, rather than the previous 100%, of the Venezuelan tax payable is granted.[113]

The new law establishes that the tax is incurred upon the death of the deceased and that the payment of the tax is due upon the liquidation of the estate.[114] The gift tax must be paid before the gift transac-

109. Law of Urgent Economic Measures, arts. 1 and 6, giving rise to Decree 581 of June 30, 1961.
110. These rates vary depending on the relationship of the parties involved.
111. 1967 IGT, art. 6.
112. 1967 IGT, art. 2.
113. *Id.*
114. 1967 IGT, art. 3.

tion can be legalized or notarized.[115]

Exemptions in the new law include (1) the family home left to parents, minor children or surviving spouse if its value does not exceed Bs. 150,000,[116] and (2) small and medium plots of land being used for farming and animal husbandry if within size limitations to be established in the Regulations.[117]

The definition of a gift has been bolstered to cover present obvious tax avoidance practices. If market price exceeds by 20% or more the sales price established in transactions between certain related persons the excess will be deemed to be a gift.[118] Gratuitous partial or complete forgiveness of debts is also deemed to be a gift unless such forgiveness meets Commercial Code requirements for bad debts or bankrupts or unless it is the Government who forgives the debt.[119] Finally, waivers or assignments of credits or inheritances in favor of third parties are deemed to be gifts in the absence of consideration except in the case of an heir who renounces in favor of all his co-heirs indiscriminately.[120]

Prior law treated each gift and bequest separately. Consequently, the impact of progressive rates could be easily avoided. The 1967 law provides that all amounts received free of consideration by a taxpayer from the same testator during a five year period will be lumped together as one transfer for purposes of determining the applicable tax. Appropriate credits are provided for taxes paid on the separate gifts.[121]

Another effort to eliminate avoidance practices is the disallowance of several previously accepted deductions from the deceased's gross estate in calculating the taxable estate. To prevent agreements between debtors and creditors designed to reduce the taxable estate, debts on which the statute of limitations has run but which are confirmed by the testator are not allowed as deductions.[122] Debts declared or recognized in the will or those contained in private documents (i.e. not notarized and made public record) are also disallowed.[123] Since the Tax Administration has no way to determine whether debts incurred

115. *Id.*
116. 1967 IGT, art. 12.
117. 1967 IGT, art. 4, *para.* 1°.
118. 1967 IGT, art. 7, *para.* 1°.
119. 1967 IGT, art. 7, *para.* 2°.
120. 1967 IGT, art. 7, *para.* 3°.
121. 1967 IGT, art. 9, art. 15, *para.* 2°.
122. 1967 IGT, art. 20, *para.* 1°.
123. 1967 IGT, art. 20, *para.* 2°.

or to be paid outside of Venezuela really exist or are validly enforceable, such debts are not deductible unless they represent an investment in Venezuela. Even where this requirement is met, the debt is not deductible if it is guaranteed by property located outside of Venezuela.[124] Finally, certain loans obtained by the deceased from relatives or business entities which he and his relatives control will not be recognized as deductions unless it is proven that the loan proceeds were invested to increase the deceased's net worth.[125]

Suggestions of the Report not adopted include: 1. setting a relatively high exemption level so as to avoid valuation problems in returns with a low revenue yield; 2. eliminating the element of relationship of the recipient to the decedent or donor as a criterion for the application of different tax rates; 3. merging the administration of this tax with the Income Tax Administration; and 4. applying the Venezuelan tax to foreign real as well as personal property received as an inheritance or gift.

## III. Income Tax Administration[126]

Since 1963, the organization of the income tax administration has been marked by an emphasis on decentralization and the reinstatement of the Regional Office system which was discontinued in 1949. Regional Offices in Maracaibo, Valencia and Barcelona are taking over increasing amounts of operational responsibility from the Central Administration, following methods and procedures tested in the Caracas Regional Office. The Central Administration is consequently less burdened with operations and can devote its time to planning and policy. This reduced operational burden in part made it possible for the members of the income tax commission which drafted the 1967 law to concentrate their efforts on that project for an extended period of time.

The Division of Regional Offices in the central tax administration is charged with the coordination of regional interpretation, application and enforcement of the tax law. This is also one of the responsibilities of the Deputy Administrator, a new position created along the lines suggested in the Report. Although there will continue to be central coordination, it is planned that all of the Regional Offices will even-

124. 1967 IGT, art. 20, *para.* 3°.
125. 1967 IGT, art. 20, *para.* 4°.
126. All information on the tax administration is as of June 1966.

tually become relatively independent and self-contained units of the tax administration. However, certain operations, notably the data processing center now found only in the Caracas office, are not likely to be decentralized.

Decentralization was mentioned in the Report as a possible course to be followed in the event of a large increase in the number of taxpayers. Declarations (255,000 in 1963) did in fact more than double between 1958 and 1963, when the reorganization was officially launched.

The "essential first step" in administration recommended by the Report, the redesign of the declaration form, has yet to be taken. Taxpayers are still required to file a long form in triplicate, one copy of which is stamped and signed by the Tax Administration and returned to the taxpayer. The taxpayer does not calculate his own tax but simply fills out information pertaining to income from different sources, leaving the determination of tax to the Administration.[127] Consequently, no payment is received with the declaration and none may have to be made until considerable time after the declaration is filed.

Despite efforts at developing a comprehensive master list of taxpayers and the establishment in 1962 of a list in the data processing center containing information on 174,000 taxpayers, there is still no sure means of ascertaining whether or not all taxpayers have in fact filed returns. In this connection, no method yet exists whereby a taxpayer's complete record can be readily obtained; consequently, bills are often issued for amounts already collected or for assessments being appealed.

### *A. Processing of Declarations*

The processing system has been largely redesigned. Receipt of declarations and checking for their completeness as to name, address, signature, etc., is virtually the same as described in the Report except that declarations are now processed in the Regional Offices rather than in the Central Administration. Taxpayers are still not required to declare on the basis of a fiscal year which ends on the last day of a given month.

Beyond these first stages of processing, the system has been revised. Following the initial review for completeness, declarations without a withholding statement attached are separated out to await receipt of

127. 1967 ITL, art. 86, provides that the Ministry of Finance may order taxpayers to calculate their own tax.

the forms which are requested of the taxpayer by mail. The rest proceed to be classified.

Classification is now handled by the Tax Determination and Codification Department where the declarations are initially separated into two major groups, ordinary and special, and several sub-groups. Ordinary returns are considered to be those falling into four categories: income up to Bs. 100,000, income between Bs. 100,000 and Bs. 200,000, exempt income, and declarations having no tax liability. Special returns are those declaring income above Bs. 200,000, those showing receipt of royalties, estimated income returns, supplementary returns and those claiming reductions in applicable rates due to reinvestment of earnings. After classification, the declarations proceed through the stages of mathematical verification, tax calculation, and review similar to those described in the Report.

Some changes must be noted in addition to those introduced into the classification procedure. In the interest of speed, only those declarations having discrepancies which cannot be routinely corrected are pulled out of the processing stream and sent to the Investigation Department. All others which raise questions or doubts are rubber stamped with coded observations and then moved along. Only after the bills have been issued will the time be taken to review these declarations, resulting, where appropriate, in an amended bill. The previous practice of doing a preliminary card punching in the Statistics Department has been eliminated. The declarations now complete the liquidation process before arriving at the data processing stage.

All special declarations and those ordinary declarations which for some reason cannot be machine processed; e.g., declarations for a short tax year, are processed manually by liquidators. The liquidators calculate tax liability, fix fines, decide the dates and amounts of installment payments of tax liability, and draft bills for taxpayers whose liability has been determined by the Controller's Office review group or by the Investigation Department. The liquidators' work is completely checked by reviewers before bills are prepared.

Bills are made out in seven copies and signed mechanically by the supervisor unless a fine is included or unless it is a special declaration in which cases he must sign manually. Ordinary returns have their bills calculated and printed automatically unless, as noted above, for some reason they cannot be machine-processed. Notices of exemption and the cards which the taxpayer signs and returns to acknowledge receipt of his tax bill are also printed electronically. This procedure is carried out through punch cards and electronic revision which combines, on a new tape for storage, old and new data pertaining to the same taxpayer.

The few specific recommendations of the Report in the billing area were almost completely ignored. The Report suggested that a single printed punch card be used as a bill, urged elimination of the requirement that bills be signed, doing away with the receipt card sent to the taxpayer with his bill, and finally, in strongest terms elimination of the costly duplication of effort by the Controller's Office checking all of the work done by the Tax Administration. None of these suggestions were followed.

### *B. Collection Process*

The sections of the Report describing the receiving offices and the system of accounting for payment are still accurate. Delinquent accounts are now the responsibility of the data processing center which sends out requests for payment at three-month intervals to the regional offices for transmission to the taxpayers. All settlements, payments, appeals, extensions or other administrative or judicial dispositions are put into writing with a copy going to the data processing center for the proper adjustment on its list of delinquent taxpayers. All information pertaining to taxpayers' names and addresses is also sent back by the regional director.

After the third request for payment, a list of those accounts still outstanding is sent to the regional director who reviews it together with the chief of his legal section. They make any comments they deem appropriate and return the list to the head of the data processing center who then distributes the cases for judicial collection among lawyers, some of whom are employees of the Administration while others are outsiders contracted especially for this purpose.

Delinquent taxes have increased steadily, reaching over Bs. 500,000,000 in 1965. During the last quarter in 1965 the realization that a certificate of solvency by itself (see discussion below) would not be enough to ensure compliance resulted in a formal effort to improve collections by hiring a large number of attorneys to pursue outstanding accounts. Contrary to the Report's recommendation, interest on overdue taxes is still billed separately, and is often not billed at all.

### C. *Certificates of Solvency*

The Report recommended simplification and expansion of the system of certificates of solvency, or tax clearances, which is an indirect method of forcing taxpayers to file declarations and pay their taxes. The major administrative problems foreseen by the Report were:

1. expansion of the system without requiring solvency certificates from taxpayers with respect to whom such enforcement would be superfluous, e.g., wage earners whose tax liability would be satisfied through withholding; and,
2. selection of periodic occasions — for taxpayers with respect to which indirect enforcement would likely be effective — on which they would be required to present their solvency certificates.

It was suggested in the Report that the receipt of payment given to the taxpayer should itself serve as the solvency certificate in most cases. Persons who had not been obligated to pay a tax and who consequently did not have a receipt of payment would be required to apply for a certificate which would be issued immediately if the application were co-signed by a reliable guarantor, or after a check of the files if no guarantor appeared. Special validations of the receipts would be required for taxpayers leaving the country, businesses seeking to liquidate, estate administrators prior to distribution, and for others in situations in which it was imperative to collect any taxes accrued between normal filing dates.

The system has been expanded in the sense that two new instances requiring a certificate of solvency were added in 1961. The first was upon the legalization of documents evidencing the transfer or mortgage of real property.[128] The second was in the case of a public employee earning more than Bs. 1,000 per month before he could receive his salary corresponding to the second half of September of each year.[129]

Requiring a certificate of solvency in the case of the public employee appears to be superfluous for two reasons. In the first place, withholding assures tax collection, particularly when the withholding agent is himself a government employee. Secondly, the public employee would seem to be particularly sensitive to his civic responsibilities. In any case this requirement proved to be administratively

128. 1961 ITL, art. 74, *para.* 3°. Resolution 1301 of May 16, 1961, G.O. No. 26,533 of May 16, 1961, defined the areas of the country where this requirement was to be applicable.

129. 1961 ITL, art. 74, *para.* 6°. Resolution 2998 of Sept. 26, 1961, G.O. No. 26,664 of Sept. 26, 1961.

unwieldly and public employees can now file a simple sworn statement that they have no outstanding tax liability.

The solvency requirement for the legalization of documents also encountered rough waters, but for different reasons. Apparently the validity of many pre-1961 transfers of real property were jeopardized, as in the case of purchases from a bankrupt. Consequently the requirement was modified five months after its enactment by limiting its impact to prospective transfers.[130]

The 1967 Income Tax Law retains both of the above requirements. In fact, the 1967 Law contains an almost verbatim duplication of the corresponding provision on certificates of solvency contained in the 1961 Income Tax Law. The new law does, however, add a provision which empowers the Executive to issue regulations broadening the application of the certificate of solvency system.[131]

While the number of instances requiring a certificate of solvency has been increased, the number of certificates issued initially evidenced a real contraction of the system instead of the expected expansion. The number of tax declarations filed annually doubled from 1958 to 1962, but the number of certificates issued increased by only 10%. However, part of the reorganization effort of the Tax Administration begun in 1963 was the designing of a more efficient system of issuing certificates. This system was put into effect at the end of 1964. Perhaps as a partial consequence of the new system, the number of certificates issued rose to a 1965 level of 224,000 as compared with 165,000 in 1958.

The new system of issuing certificates of solvency is still based on specific application rather than automatic issuance as recommended in the Report. The receipt for taxes paid is not sufficient, but the processing of applications has been expedited so that an applicant can obtain his certificate either immediately or within three days of filing his application. This speed up has been made possible by relying on a combination of guarantees and sworn statements. Venezuelans and resident aliens must present a tax receipt issued within four months of the application date and offer an acceptable guarantor if they wish to leave the country. Non-resident aliens leaving the country must

130. Decree 640 of Oct. 27, 1961, G.O. No. 26,689 of Oct. 27, 1961. However, Article 101, *parágrafo* 3°, of the 1967 ITL reverts to the original wording of the 1961 ITL, art. 74, *para.* 3°, and does not appear to limit the requirement to prospective transfers nor to transfers effected since the date of Decree 640.

131. 1967 ITL, art. 102.

present a tax clearance up to the date of termination of their activity in Venezuela. Businesses must also present a tax receipt dated within four months of the application date unless the certificate is requested for purposes of liquidation, in which case a tax clearance up to the date of business termination is also required. The applicant who claims he has not had to file and consequently has no receipt is simply asked to sign a sworn statement to that effect. Applications are quickly checked against a register of outstanding accounts and automatically approved unless the applicant is a non-resident leaving the country or a business about to liquidate. These latter two categories are further checked with the Information Section to ensure that there are no outstanding accounts since such claims will become practically unenforceable once the applicant leaves Venezuela or liquidates.

Following the issuance of certificates on the strength of the applicants' statements and a routine check, a careful audit of applications is made on a random sample basis.

The new law introduces a similar means of assuring compliance with the tax laws. All industrial, commercial and service establishments and independent professionals must, in their offices or places of business, prominently exhibit a certificate issued by the Tax Administration substantiating the payment of taxes due for their previous fiscal year.[132]

### D. *Withholding*

The 1961 Reform increased withholding on wages and salaries to include an amount representing complementary tax in addition to the amount being withheld by reason of the schedular tax.[133] The amount of complementary tax withheld was based on a progressive table containing 145 brackets of monthly income with appropriate deductions for various family exemptions.[134]

The amounts withheld for schedular and complementary taxes were required to be paid over to a receiving office no more than fifteen days following the date of retention, and withholding statements were provided monthly and annually to the taxpayers.[135] No withholding

132. 1967 ITL, art. 99.
133. 1961 ITL, art. 52.
134. Resolution 926 of Feb. 21, 1961, G.O. No. 26,487 of Feb. 22, 1961.
135. Decree 613 of Aug. 11, 1961, G.O. No. 26,629 of August 6, 1961, (hereinafter Decree 613), art. 5.

was required on payments made in kind.[136] Within sixty days following each half year or termination of activity, a detailed account of amounts withheld was required to be submitted to the Tax Administration.[137]

The 1961 Reform also added, as a condition to the deductibility of expenses representing payment of interest, royalties or other distributions to non-residents, that the taxpayer withhold the schedular and complementary taxes on such payments. For purposes of determining what complementary tax bracket to apply in the withholding process, the amounts paid out to any one taxpayer during the year were accumulated.[138]

The above changes in withholding prior to the 1967 law, along with the normal growth in the system, led to an increase in total amounts withheld of more than 500% between 1958 and 1967, representing Bs. 250,000,000 in 1965.

The withholding procedure, which the 1967 law leaves to the regulations,[139] continues to be largely the same under the new regulations as under the old law.[140] The amount to be withheld on salaries and wages is now determined by a table containing 328 rather than 145 brackets. As under the 1961 law, amounts withheld are paid over within fifteen days, monthly and annual withholding statements are provided to the taxpayer. Withholding agents now file reports quarterly rather than every six months.

The instances in which withholding is required as a condition to deductibility have been increased in the 1967 law. The prior withholding requirements on the payments to non-residents mentioned above,[141] on payments of wages and salaries, on commissions to real estate brokers and on premiums to foreign insurance companies have been continued.[142] New instances brought into the law are the payment of film exhibition rights paid to non-residents[143] and the payment

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136. Decree 613, art. 7.
137. Resolution 2476 of Aug. 9, 1961, G.O. No. 26,623 of Aug. 9, 1961.
138. Decree 613, art. 3.
139. 1967 ITL, art. 88.
140. Decree 729, Jan. 3, 1967.
141. 1967 ITL, art. 59, *para. segundo;* art. 57, *para. segundo.*
142. 1967 ITL, art. 15, *paras. sexto* and *octavo;* art. 38 *paras. tercero* and *séptimo.*
143. 1967 ITL, art. 15, *para. octavo;* art. 38, *para. séptimo.*

of transportation costs by oil and mining taxpayers.[144]

A straight-forward obligation to withhold, not necessarily related to deductibility, exists in four other cases, including two hold-overs from prior law and two newcomers. The established requirement that race tracks, lotteries and others who pay out fortuitous gains withhold the entire 30% tax has been continued.[145] Also, withholding agents continue to be required to withhold amounts representing installment payments agreed upon between a public employee and the Tax Administration in settlement of the employee's tax liability.[146] The new instances include withholding on any payments made to foreign film producers or distributors,[147] and withholding on dividends and distributions.[148] Withholding on dividends and distributions takes four different forms: 1% of the amount of normal dividends and of dividends on bearer shares if the holders first convert the bearer shares into registered shares; 30% in the case of dividends on bearer shares whose holders do not convert them; 15% on dividends paid to non-residents; and a withholding by agencies and branches of non-mining or non-oil companies organized outside of Venezuela, amounting to 15% of their net after-tax income as a presumed dividend, whether or not there is an actual distribution.

The law grants the Executive the power to waive the filing requirement for all resident taxpayers whose total income does not exceed Bs. 48,000 and who have paid all their tax through withholding.[149] Finally, the Executive is authorized to expand the withholding requirement to other cases.[150]

### *E. Pay-As-You-Go*

The suggestioh of the Report to put more taxpayers on a current

144. 1967 ITL, art. 38, *para. séptimo.* This is limited to rate "B" taxpayers but includes all transport expenses, not just those paid to non-residents. On the other hand, a similar requirement on rate "A" taxpayers, applicable only to transport costs paid to non-residents, was included in the bill but was eliminated by Congress.

145. 1967 ITL, arts. 88 and 76.

146. 1967 ITL, art. 91. This provision was introduced in Article 52 of the 1961 ITL. The 1967 ITL has a clause empowering the administration to apply this requirement to the private sector as well.

147. 1967 ITL, arts. 88 and 20, apparently a broader requirement than those under Article 15, *parágrafo octavo* and Article 38, *parágrafo séptimo* for withholding on payments made for film exhibition rights.

148. 1967 ITL, art. 51.

149. 1967 ITL, art. 81, *para. tercero.*

150. 1967 ITL, art. 88, *para. tercero.*

payment basis in addition to those subject to withholding was adopted through the introduction of pay-as-you-go. The system is based on an annual declaration of estimated income and quarterly payments of the resulting estimated tax.

Taxpayers in mining and oil were singled out in the 1961 reform to lead the way in the estimated tax area, but the law stipulated that the new pay-as-you-go system could be subsequently applied to other classes of taxpayers.[151] Mining and oil taxpayers are required to file during the first quarter a declaration of their estimated annual income. The tax on this estimated amount is paid in four quarterly installments made in the two weeks following the end of each quarter. Each of the first three payments amounts to one fourth of the tax on the estimated income and the fourth payment is adjusted in relation to the income declared in the definitive return. If the sum of the first three payments exceeds the amount actually due under the final return, the taxpayer may petition for a refund.[152]

The 1961 law established the general principle that the previous year's income would serve as the basis for the estimated declaration under the pay-as-you-go system. The details of the system were, however, left to subsequent regulations. The basic guideline adopted in the regulations was that, except in unusual cases, estimated income could not be less than 80% of the previous year's income. The amount of estimated investment leading to an effective rate reduction could not exceed 80% of such investment in the previous year.[153]

Extension of the pay-as-you-go concept to other than mining and oil taxpayers came about shortly as a result of the Law of Urgent Economic Measures and resulting decrees which went into effect later in 1961.[154] Taxpayers earning schedule 3 business income in excess of Bs. 200,000 during the previous year were required to pay on a current basis using the same 80% guideline described above.[155] It was originally stated that this new group would pay the tax due on estimated income in the course of the year for which income was estimated, as is required of mining and oil taxpayers. However, the new group is permitted to wait until the end of the second quarter before filing declarations of estimated income, and the tax is payable

151. 1961 ITL, art. 53.
152. 1961 ITL, art. 54.
153. Decree 486 of Mar. 28, 1961, G.O. No. 26,516 of Mar. 28, 1961.
154. Law of Urgent Economic Measures.
155. Decree 593 of July 15, 1961, G.O. No. 26,603 of July 15, 1961.

in four quarterly installments beginning with the third quarter. Consequently there is still some lag in payment as compared with the mining and oil sector. Longer periods of payment are allowed to both groups in the case of the first declaration of estimated income.

Nothing in the new law would indicate that this pay-as-you-go system will be substantially changed, although regulations have not yet been issued. It does appear that the scope of the system will be increased somewhat since the level of income at which non-oil and non-mining taxpayers become subject to the estimated return procedure has been lowered to Bs. 100,000.[156]

### *F. Refunds*

The expanded role of withholding and the introduction of the limited pay-as-you-go system described above carry with them the necessary corollary of an increased number of instances calling for refunds.

In describing the refund system, the Report noted that refunds were a matter of grace, often depending on whether the budget appropriation for refunds had been exhausted at the time the refund claim was processed. Unfortunately, the budget limitations still exist, and an extremely complex procedure has been established for the processing of refund claims. The amount refunded on any one application cannot exceed one-twelfth of the annual amount budgeted for refunds, nor can all refunds approved in one month exceed that same figure. To complicate matters still further no refund application form is supplied to the taxpayer.

All applications, regardless of size or nature, follow an arduous route up through the levels of investigator, supervisor, head of section, head of department, Regional Director, Deputy Administrator, Director General of the Ministry of Finance and back down to the Office of the Administrator, the budget department, the Deputy Administrator and, finally, the Accounting Department.

Despite the extended periods during which the government may hold funds properly belonging to the taxpayer, no interest is paid.

### *G. Taxpayer Appeals*

Taxpayers for many years have had access to an administrative appeal to reduce or eliminate the amount of a fine levied by the Tax

156. 1967 ITL, art. 84; art. 89 *paras. primero* and *segundo.*

Administration.[157] The Administration may, as a matter of grace, grant the taxpayer's request for a reduction in fine if the taxpayer demonstrates having had no intention to violate the law. The processing of such taxpayer appeals is of a similar complexity to that described for refunds above.

Not until 1967 were taxpayers outside of the oil and mining area provided with a formal administrative procedure by which the Administration could be required to reconsider its determination of a taxpayer's tax liability. This was true whether or not the administrative determination involved increasing declared income, disallowing declared deductions or otherwise disagreeing with the information contained in the tax return.[158]

Previously, the taxpayer was simply billed an amount and, even if he disagreed with only a small portion of the tax determined, he had to take an appeal on his entire bill to the Tax Court within ten days, first paying the total assessed tax or posting bond. Only after such an appeal had been filed in court could the Administration reconsider its position, during a period of sixty days, after which it could amend its determination and issue a new bill. If the Administration insisted on its determination or if the taxpayer were still unsatisfied with an amended determination, the court procedure would continue. If the taxpayer lost in the Tax Court, he could take a further appeal to the Supreme Court.

In addition to the cumbersome legal procedure a taxpayer had to subject himself to in order to raise questions of interpretation, there existed the risk, between 1958 and the 1967 law, that the Court would declare the taxpayer's argument to be wholly without substance, in which case he would be assessed a 1% per month charge on the entire amount of the bill.[159] The combination of the 1% penalty on the whole amount of the taxpayer's bill and the lack of initial administrative reconsideration made it unlikely that a taxpayer would raise doubtful points of interpretation, particularly if the disputed amount represented a minor portion of the whole bill.

Under the new law, the taxpayer can, within fifteen working days after receiving his bill, petition the Regional Office for reconsideration, provided he posts bond or otherwise guarantees payment of the dis-

157. 1967 ITL, art. 115. 1961 ITL, art. 70.
158. 1967 ITL, arts. 116-126.
159. *See* Appendix C of the REPORT.

puted amount.[160] The taxpayer has thirty days in which to present evidence in support of his petition which should state the legal and factual bases of his position.[161] The Administration then has 90 days to consider the case, during which it may ask the taxpayer for additional information, books of account and other evidence it deems necessary. In complex cases, the Administration may, through agreement with the taxpayer, prolong its consideration up to an additional 180 days.[162] If the Administration does not pass on the petition within the alloted time, or if the taxpayer is totally or partially disappointed by the decision which does issue, he may appeal to the Tax Court on that portion of his tax liability upon which no agreement has been reached.[163]

If the taxpayer withdraws his petition before an administrative decision is reached, or if the period for appealing the administrative decision before the Tax Court lapses, he will be subject to an additional 1% per month penalty on the amount of the unpaid tax objected to, calculated from the date he filed his petition for administrative reconsideration.[164]

When the taxpayer's grievance is based on a "material error", that is an oversight, arithmetical error, or some such factor which is easily correctible, the above procedure need not be followed. The taxpayer can simply resolve the problem directly with the Regional Office without having to post bond or go through the formal steps of the reconsideration procedure.[165]

Apparently, although the law seems to contemplate exhausting the administrative remedy, there is no explicit requirement that the taxpayer do so before initiating a judicial process. Within fifteen working days of receiving his bill, the taxpayer can file directly with the court.[166] The Administration is then given a period of 120 working days to reconsider its position.[167] If the taxpayer loses, he may be sub-

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160. 1967 ITL, arts. 116, 120. It is not clear from the new law whether the petition must be based on the entire amount of the bill or simply on a portion of the bill, although the latter would appear to be the case.
161. 1967 ITL, arts. 118, 119.
162. 1967 ITL, art. 122.
163. 1967 ITL, art. 123.
164. 1967 ITL, art. 125. *See* note 160 *supra*.
165. 1967 ITL, art. 126.
166. 1967 ITL, art. 127.
167. 1967 ITL, art. 130.

ject to court costs up to a maximum of 10% of his tax liability.[168] He may appeal to the Supreme Court only if the amount in controversy exceeds Bs. 5000.[169]

Originally, the bill before Congress did not allow the taxpayer to by-pass his administrative remedy unless the amount involved exceeded Bs. 1000. This limitation was deleted, but the Bs. 5000 limitation on Supreme Court appeals was retained.

At the time of the Report, one of the members of the three-man tax court was required to be an accountant. This requirement was eliminated in 1958, as noted in the Report's Appendix C. The new law again restricts the personnel qualified to serve on the court, this time stating that they must all be lawyers of renowned competence in income tax matters.[170]

Finally, some changes have been introduced into the statute of limitations. Although the Report's recommendation, that the statute not begin to run until the filing of a declaration, was not adopted, a seven-year statute is prescribed in this case as opposed to a five-year statute when declarations have been filed.[171] The running of the statute is suspended if the taxpayer requests administrative reconsideration or pursues a court action.[172] However, new periods begin to run upon the Administration's official request that a declaration be filed or, indeed, upon the taxpayer's unsolicited filing of a declaration corresponding to a past tax year. Also, a new five-year period begins when the Administration finds a deficiency, whether a declaration has been presented or not, and when administrative or judicial collections are commenced.[173]

## IV. Conclusion

This article has made reference to whether or not recommendations of the Shoup Report have been adopted in subsequent legislation, particularly the tax law in 1967. Another and more striking relation between the Report and the new law is the lapse of seven years between the two. It is clear that the Report was not the initiating force

168. 1967 ITL, art. 129. In addition he is still subject to the 1% per month penalty if the claim is found to be wholly without substance.
169. 1967 ITL, art. 132.
170. 1967 ITL, art. 135.
171. 1967 ITL, art. 147.
172. 1967 ITL, art. 152.
173. 1967 ITL, art. 153.

behind the enactment of the new law; rather, the decision to enact a new law was a political decision reached independently of the Report. Those responsible for the formulation of the new law no doubt studied their copies of the Report and found that its observations and recommendations had not lost relevance. One or more of those responsible for the new law were also members of the enthusiastic group of Venezuelans who took an active part in exchanging views with the members of the Shoup Commission at the time the Report was drafted.

The Venezuelan experience suggests that a serious effort toward prompt reform of the tax laws of a country with the assistance of foreign tax advisors should contemplate not only a concentrated period of study and consultation for the purpose of turning out a report, but also the establishment of a continuing process of analysis and development of alternatives to the end of creating a new law. More often than not, it is in the working out of technical details that expert help is needed; today foreign technicians will not be the first persons in the host countries to suggest broad policy changes such as the elimination of schedular taxes or the taxation of dividends.

It is virtually impossible to determine to what extent the changes in the new law are derived from the Report's recommendations. It is true that various changes suggested in the Report, as noted above, can be found in the new law. A separate rate structure applicable to corporations was introduced in 1961; the new law eliminates the schedular taxes and the corporate tax and replaces them not with a single progressive tax but rather with three progressive taxes whose application depends on the source of the income; dividends are now taxed, but the Report's emphasis on the "gross-up" aspect of any credit mechanism was ignored; recognition of the taxpayer's family status has been achieved, albeit through credits rather than exemptions as suggested by the Report; a medical expense deduction is included in the new law, but it is not limited to that amount which exceeds a minimum figure, as suggested. Furthermore, most of the Report's suggestions in the area of inheritance and gift taxes were adopted in the new law.

On the other hand, the use of the tax system to give incentives continues despite the Report's objections; numerous step or "notch" problems — cases where a small increase in income results in the loss of exemptions — remain; no loss carry-back has been introduced nor has any provision been made to spread capital gains income; progressive rates have not been applied to non-residents. The inheritance and gift tax does not adopt various suggestions of the Report, including the setting of a relatively high exemption level, the elimination of the element of relationship of the recipient to the decedent or donor as a determinant of different applicable rates, and the merging of the administration of this tax with that of the income tax.

However extensive the relationship between the Report and the new substantive law might be, it is fairly clear that there is less of a relationship between the Report and subsequent changes in tax administration. With the notable exception of a pay-as-you-go system, few of the Report's specific suggestions relating to administration have been adopted. The various changes introduced into the administration of the income tax to improve its operation bear little resemblance to the Report's recommendations, but may have been at least in part the result of attempts to eliminate some of the trouble spots of administration pointed out by the Report. Moreover, the changes in administration which may have occurred as a result of the implementation of the new law have not been examined because the cutoff date for this article for information on tax administration is June, 1966.

# Corporate Residence Rules for International Tax Jurisdiction: A Study of American and German Law

RUDOLF WEBER-FAS*

*Editorial Introduction*

In order to meet its fiscal needs and to advance its social, economic and political goals, the modern nation-state asserts the right to take its tithe of the wealth present and the economic gain produced within the ambit of its power. While such national fiscal claims may not always be as modest as they should be, and are not always in line with those of other nations — thus giving rise to those problems which have been all too generally referred to as instances of international "double taxation" — there exist no rules of international customary law which limit the extent of any country's tax jurisdiction to the confines of its territory.[1]

A legal basis for international tax jurisdiction has been found in the sovereignty of the state.[2] In only a few countries are there any local constitutional barriers on the extent to which tax jurisdiction may be claimed. It has generally been found "that within its own legal and fiscal framework a country is free to adopt whatever rules of tax jurisdiction it chooses. This is true no matter how broad may be the reach of the resulting tax net."[3]

In order then to answer the fundamental question of how far its jurisdictional claim shall go, in order to distinguish what is one country's and what is its neighbor's, national claims of jurisdiction to tax have been built on theories which, in varying mixtures, employ criteria of (1) status of the taxpayer and (2) locus or source of income.[4]

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1. *See* United States v. Bennett, 232 U.S. 299 (1914); Cook v. Tait, 265 U.S. 47 (1924); *see also* Norr, *Jurisdiction to Tax and International Income,* 17 TAX L. REV. 431 (1962).

2. Mersmann, *Die Ausgleichung und Harmonisierung der Steuersysteme* [1959/60] STEUERBERATER-JAHRBUCH 45.

3. Norr, *supra* note 1, at 431.

4. *See* HARVARD LAW SCHOOL INTERNATIONAL PROGRAM IN TAXATION, WORLD TAX SERIES: TAXATION IN THE UNITED STATES, at 981 et. seq. (1963).

Some countries restrict the application of their tax law to income derived from activities within that country — to domestic tax bases — and thus emphasize the criterion of source ("source jurisdiction"). The United States and the Federal Republic of Germany, however, are among those states which tax certain persons on income derived from foreign as well as domestic sources on the theory that the taxpayer as such is the subject of taxation ("personal jurisdiction") — that it is the taxpayer's status as resident, domiciliary, or citizen of a country which confers on the state the right to tax him. For purposes of personal income taxation, for example, United States citizenship or residence provides the personal status for subjecting the individual to United States taxation of his world-wide income.[5]

Since corporations are neither citizens nor residents of any country in the sense in which a natural person may be, countries taxing on the basis of personal jurisdiction have developed tests of corporate residence to supply the necessary jurisdictional element.[6] For purposes of the corporate income tax[7] the *general* jurisdictional requirement for United States taxation of world-wide income is that a corporation be "created or organized in the United States or under the law of the United States or any state or territory."[8]

This criterion, which determines whether or not the global income of a corporate enterprise falls within the full reach of United States taxation, is the *general* United States "corporate residence rule." Together with its modification through certain indirect residence rules and with comparable criteria of other countries — especially those employed in West Germany[9] — this rule is the center of discussion in the following article.

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5. INT. REV. CODE OF 1954, § 1 and § 61, as limited by § 871 (a). Non-resident aliens are taxable only on their United States source income.

6. De Beers, Ltd. v. Howe, [1906] A.C. 455.

7. INT. REV. CODE OF 1954, § 11 (a), as limited by § 882 (a).

8. INT. REV. CODE OF 1954 § 7701 (a) (4). Foreign corporations are generally taxable on their United States source income. Exceptions to this rule are to be found in the case of certain Canadian and Mexican corporations which are treated as domestic rather than foreign corporations for purposes of the income tax laws. INT. REV. CODE § 1504 (a), Treas. Reg. § 1.1502-2 (b) (3), *See generally* TAXATION IN THE UNITED STATES, *supra* note 4, at 1098, and n. 3.

This *general* corporate residence rule is also modified indirectly by the Foreign Personal Holding Company and the Controlled Foreign Corporation provisions of the Code which provide, in specific instances, for elimination of the corporation as a separate taxable entity and for direct taxation of United States shareholders on corporate earnings. *See* pp. 192-199 *infra.*

9. *See* pp. 179-190 *infra.*

*Corporate Residence Rules for International Tax Jurisdiction* focuses on legislation and on treaty law of the United States and West Germany. The analysis examines both American and German unilateral rules of corporate residence, as set forth in statute law, and their application and interpretation by courts and administrators, in practice and through case law. Considerations of international and constitutional law, the problem of taxpayer avoidance of corporate residence rules, the legislative response by way of loophole-plugging enactments, and the increasing complexity in the statutory provisions as a result of remedial legislation — especially in the United States — become the basis for a discussion of the need for re-examination of unilateral corporate residence concepts in United States and German tax laws.

The obvious world-wide lack of uniformity in unilateral corporate residence rules is brought into focus through an examination of bilateral "residence" provisions, or their absence, in the tax treaties of the two countries studied. Part V, "Comparative Analysis," analyzes the need for corporate residence rules against the background of legislative histories, historical notions of corporate locus, tax and non-tax law theories of the modern business corporation's nexus with a specific sovereign, and approaches to the resolution of conflicting residence concepts suggested in multi-national studies and draft conventions.

American business interests abroad may not have played a very vital part in either the American economy or in world trade at the time of the adoption of the United States' criterion of corporate tax residence ("created or organized in the United States . . ."), but the expansion of American overseas investment, the proliferation of American tax treaties, in all of which the United States reserves the right to determine according to its own unilateral test whether a corporation is a United States corporation,[10] and the increasing complexity of American tax statutes[11] are factors which call for recollection of the remarks made by Stanley S. Surrey in discussing the Treasury studies out of which grew the Foreign Investors Tax Act of 1966.[12]

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10. *See* pp. 210-211 *infra*.

11. BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 262 (1966).

12. Pub. L. No. 89-809, §§ 101-110 (Nov. 13, 1966), 80 Stat. 1539. In his comments Mr. Surrey was concerned with a different trans-national impact of the United States income tax laws, but the admonition of his remarks would seem well-taken with respect to the problem focused on in Mr. Weber-Fas' article.

> "[T]he case for re-examination of [the rules governing the taxation of foreigners earning income from United States sources] need not be pitched in proof of a large absolute increase in foreign investment in the United States. Rather it is necessary to consider whether changes are appropriate from the standpoint of a more rational application of our tax to foreigners, and hopefully one that would be somewhat simpler."
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> * * *
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> ". . . The United States, with its large flows of capital and goods in and out of our country, has a responsibility to take a major role in developing a proper international tax framework against which the tax rules of any particular country can be considered."[13]

The "case for re-examination" of the United States corporate residence rules for international tax jurisdiction should be presented not only to the student of taxation but to students of treaty law and of legislation. Where transnational aspects of income taxation are concerned, statute and treaty law dominates the field.

> "Particularly in the United States, the legislature has stated in considerable and at times excessive detail the governing rules in this area. Courts have played primarily an interstitial role in the development of principles, through their interpretation of some of the more troublesome statutory provisions. They have not been called upon to assume the larger task of developing basic policies or principles to aid in the interpretation of the relatively barebone provisions treating questions of transnational reach which . . . [are] characteristic of criminal legislation and of much economic regulation."[14]

It is to those engaged in the larger task of developing basic policies or principles that the following discussion and the research on which it is based are commended.

*B. L-S.*

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13. Surrey, *Treasury Study Will Consider New Rules for Taxing Foreigners Receiving U.S. Income.* 22 J. TAX'N 34, at 37.

14. STEINER & VAGTS, TRANSNATIONAL LEGAL PROBLEMS 889 (1967 unpublished materials for use in the Harvard Law School).

## I. The Unilateral Rules under German Tax Law

### *A. Seat or Place of Management as Corporate Residence Tests and as Criteria of Unlimited Income and Capital Tax Liability*

Corporations[1] which have either their place of management or their seat in Germany, § 1 I KStG, are subject to unlimited corporate income taxation, encompassing income from all domestic and foreign sources, § 1 II KStG.[2]

Corporations which have neither their place of management nor their seat in Germany, § 2, I(1) KStG, are subject to corporate income taxation which is limited to income from domestic sources, § 5 KStG, § 15 KStDV.

Corporations[3] which have either their place of management or their seat within the territorial scope of the German Basic Law (*Grundgesetz* abbreviated GG) or in West Berlin, § 1 I(2) VStG,[4] are subject to unlimited taxation on the entire capital of the corporate taxpayer, including assets located abroad, § 1 II VStG, § 73 BewG.[5]

Corporations which have neither their place of management nor

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1. The shorthand expression "corporation" as used in this paper includes on the German part:

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|---|---|
| a. entity of the commercial law | Kapitalgesellschaft |
| stock corporation | Aktiengesellschaft (A.-G.) |
| partnerships limited by shares | Kommanditgesellschaft (auf Aktien) (K.-G. (a.A.)) |
| limited liability company | Gesellschaft mit beschränkter Haftung (G.m.b.H.) |
| colonial company | Kolonialgesellschaft |
| mining company | Bergrechtliche Gewerkschaft |
| b. cooperative company | Erwerbs-und Wirtschafts-genossenschaft |
| c. mutual insurance company | Versicherungverein auf Gegenseitigkeit |
| d. other entities of the private law with independent legal existence | Sonstige juristische Personen des privaten Rechts |
| e. clubs, organizations and foundations without independent legal existence as well as conglomerations of property for a specific purpose | Nichtrechtsfähige Vereine, Anstalten, Stiftungen und andere Zweckvermögen |
| f. Commercial enterprises of corporations of the public law | Betriebe gewerblicher Art von Körperschaften des öffentlichen Rechts |

2. [1965] I BGBl. 450.
3. The capital tax applies to the same corporations to which the corporate income tax applies. In addition to that, the VStG applies to banking organizations of the public law, *Kreditanstalten des öffentlichen Rechts.*
4. [1954] I BGBl. 137, 296, 417 and [1965] BGBl. 153.
5. [1934] I RStBl. 1035; [1934] RStBl. 1291.

their seat in Germany[6] are subject to capital taxation only on items of property situated in Germany, § 2 II VStG, § 77 BewG.

This basic jurisdictional pattern (unlimited corporate income and capital tax liability of domestic corporations v. limited corporate income and capital tax liability of foreign corporations) has one important exception which relates to integrated foreign corporations.[7]

The statutory definitions of the terms "seat" and "place of management" as supplied by the general tax statute, *Steueranpassungsgesetz* (StAnpG), is controlling whenever these terms are used by special tax acts.

A corporation can have only one seat under German commercial law.[8] The tax law has adopted this civil law concept.[9] According to § 15 III StAnpG, a corporation has its seat for tax purposes in the place designated as seat by the corporation's charter or other basic document. If the charter fails to specify a seat for commercial law purposes, then the seat for tax law purposes is deemed to be at the place where the corporation's management is located or from which its affairs are administered. Foundations, unincorporated associations or conglomerations of property may not have a specified corporate seat under commercial law. A corporation of the important group of *Kapitalgesellschaften,* however, would not be registered and hence not incorporated without having its seat designated in its constituting document. Since the seat of a *Kapitalgesellschaft* must be within the district over which the court of registration has jurisdiction for purposes of commercial law registration of such corporations, the seat for tax purposes is practically identical with the place of a corporation's registration.

In the case of a limited liability company, the seat may be any place the company chooses. But so far as stock corporations or partnerships limited by shares are concerned, the company must regularly designate as its seat a place where the management or the administration of the enterprise is conducted, § 5 AktG of 1937, § 5 II AktG of 1965.

The seat of a corporation organized under German law must be in

6. The shorthand expression "Germany" as used in this paper means the territory subject to the German Basic Law and West Berlin. This is the territorial substratum of the KStG and VStG. *See* BLUEMICH KLEIN & STEINBRING, KOERPERSCHAFTSSTEUERGESETZ § 2 nn. 38/4 & 39/1 (1965).

7. *See* p. 183 *infra.*

8. GADOW & HEINICHEN, AKTIENGESETZ § 5 A2a (1961).

9. MATTERN & MESSMER, REICHSABGABENORDNUNG § 155 A3 StAnpG (1964).

Germany.[10] The transfer of the seat to a foreign country is judicially interpreted as a resolution to dissolve the corporation,[11] but it does not immediately terminate the corporation's status as a taxpayer. After its dissolution the corporation continues its existence as an independent legal entity until it completes the winding-up of its affairs.[12]

Since the concept of seat appears to be one of formal law which can be identified relatively easily, it is not surprising that neither the *Reichsfinanzhof*, the Supreme Finance Court prior to 1945, nor the *Bundesfinanzhof*, the present Supreme Finance Court, have been called upon to resolve the question of a corporation's seat as a matter of law.

In sharp contrast to the simplicity of determining the seat, there are often highly complex factual issues involved in locating the place of management of a corporation, which is the alternate criterion for the determination of a corporation's unlimited personal tax liability. § 15 I StAnpG defines place of management *(Geschäftsleitung)* as the center of top management *(Mittelpunkt der geschäftlichen Oberleitung)*. Locating the center of top management on the basis of social and economic data has been characterized as a purely factual determination.[13] Even though one can characterize the determination as a "mixed question" of law and fact, heavy emphasis on fact finding and analysis means that each case will be decided on the basis of its own particularities.[14]

The judicial decisions forming Appendix A to this article (pp. 240-248 *infra*) help point out the problems which arise in the typical cases where the place of management is in issue. Summarily, the place of management is where the center of top management is. Management is not identical with numerous though important business activities. No simple earmark such as location of books or funds is decisive.[15]

A corporation has only one place of management which is the center of gravity of all corporate affairs.[16] If commercial management

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10. 19 BGH E 105.

11. 7 RG E 70; 107 RG E 97.

12. 41 RG E 95; 118 RG E 340. *Contra,* GUMPEL & BOETTCHER, TAXATION IN THE FEDERAL REPUBLIC OF GERMANY 5/2.5 (1963).

13. *See* KUEHN, ABGABENORDNUNG § 15 n. 2 (1966); TIPKE & KRUSE, REICHSABGABENORDNUNG § 15 n. 2 (1963).

14. *See* Felix, *Ort der Geschäftsleitung im Steuerrecht,* 63 DEUTSHES STEUERRECHT 421; SCHMITZ, KOMMENTAR ZUM INTERNATIONALEN STEUERRECHT 183 (1957).

15. RFH Judgment of June 16, 1931, 30 I A 462, 29 E 78.

16. BFH Judgment of March 1, 1966, 65 I 13, 14 [1966] BStBl. 207.

and technical management of a corporation are located at different places, then the place of commercial management takes precedence.[17]

The office of the top manager regularly determines a corporation's place of management. However, such an office is not necessary and if it does not exist the top manager's residence may be regarded as the corporation's place of management.[18] The executives of a corporation are not necessarily the top managers for purposes of the tax law.[19] The place of management is determined by the place from where the directives and authoritative manifestations are given, not by the place where they become effective.[20] The controlling shareholder's influence upon the corporation must not be confused with managerial activity. Only permanent participation in day-to-day business activities transcends the shareholder's sphere and amounts to management of the corporation by the shareholder.[21]

The domestic commercial residence of the owner of all or most of the common stock of a corporation with a seat abroad is not a sufficient basis for holding that the corporation's place of management is in Germany even if the greater part and the most important corporate business activities take place at the owner's domestic commercial residence.[22] However, if no important managerial decisions are taken without the consent of the corporation's dominant shareholder who resides in Germany, the place of management of this corporation is in Germany even though its seat is abroad.[23]

The normal relationship between a foreign incorporated subsidiary and a domestic parent does not shift the subsidiary's place of management to Germany. Such shift, however, takes place when the domestic parent continually determines the subsidiary's business activities.[24]

As a rule, the place of management of an integrated company is determined by the place where its executives are acting.[25] However, if the integrated company behaves like an operating department of the dominant company, then the integrated company's place of man-

17. RFH Judgment of July 2, 1936, 36 III A 86, [1936] RStBl. 779.
18. RFH Judgment of July 3, 1934, 33 I A 129, 36 E 244.
19. RFH Judgment of July 3, 1936, 36 I A 150, [1936] RStBl. 804.
20. RFH Judgment of June 23, 1938, 38 II 40, [1938] RStBl. 949.
21. RFH Judgment of July 11, 1940, 39 III 135, [1940] RStBl . 706.
22. RFH Judgment of September 1, 1934, 32 I A 344, 35 E 133.
23. RFH Judgment of July 25, 1935, 35 III A 98, [1935] RStBl. 1366.
24. RFH Judgment of June 19, 1936, 35 II A 107, [1936] RStBl. 765.
25. BFH Judgment of August 9, 1957, 56 U III 215, [1957] BStBl. 341.

agement is at the place of management of the dominant company.[26]

### *B. Residence-fiction for Integrated Foreign Corporations*

#### 1. Language and Meaning of the Norm

According to § 15 II StAnpG, a non-resident corporation with independent legal existence under private law, which in economic terms is merely an operating division of a resident enterprise, is treated for purposes of tax law as if its place of management were located where either the dominating individual or the dominating corporation have their domestic residence.

This provision establishes a special treatment for certain companies with neither seat nor place of management in Germany. A company which is organized separately will nevertheless be treated as an integrated company in the sense of § 15 II whenever it would be treated as such by the turnover tax law *(Umsatzsteuergesetz)*, that is, when there is a financial, organizational and economic domination of the corporation by another (so-called *Organschaft*).[27] Thus for purposes of the residence-fiction rule, an integrated company is a corporation which, notwithstanding its formal legal independence, is subordinate to the dominant enterprise to such a degree that it cannot act independently.

The statutory fiction that an integrated foreign company has its place of management at the residence of the dominating domestic individual or corporate person is of utmost importance for tax law purposes. This fiction subjects foreign corporations to unlimited income and capital tax liability. This exceptional way of determining the tax residence is an example of the economic as opposed to the legalistic approach of German tax law insofar as it disregards legal form and gives effect to the economic implication of the legal relationship.[28]

The purpose of the provision is to discourage shifting — for purposes of tax avoidance — of income and capital out of the country. The

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26. BFH Judgment of June 10, 1964, 60 II 106, [1964] DEUTSCHE STEUR-ZEITUNG/EILDIENST 501.

27. KUEHN, *supra* note 17, at § 15 A2; MERSMANN, DIE ERTRAGSBESTEUERUNG INLAENDISCHER BETRIEBSSTATTEN UND TOCHTERGESELLSCHAFTEN AUSLANDISCHER KAPITALGESELLSCHAFTEN § 25 (1966).

28. SCHMITZ, *supra* note 14, at 189.

result is not the taxation of the dominant domestic person on the investment, but the reaching of the foreign entity in order to subject it to tax upon its total world-wide income.

### 2. Validity of the Rule under International Law

The very broad expansion of German tax jurisdiction, as contained in § 15 II StAnpG which subjects a group of foreign corporations to unlimited German tax liability, raises the question whether such a provision is valid under accepted principles of international law. Substantive conflict of the norm with a generally accepted principle of the law of nations would invalidate § 15 II because of Article 25 of the Basic Law *(Grundgesetz)*, which incorporates such rules of international law into the federal law and gives them priority over domestic statutes. International law so incorporated has a direct effect in changing the rights and obligations of persons living under German law. A generally accepted principle of international law, within the meaning of the above-mentioned constitutional provision, is one that is recognized by the great majority of nations even though Germany is not among them.[29] This common consent means the express or tacit consent of such an overwhelming majority of the members of the international community that those who dissent are of no importance as compared with the community viewed as a whole.[30]

Before one can ascertain the position of international law vis-á-vis the rule at issue, one has to determine the recognized sources of international law. For purposes of this article, it suffices to point out that, notwithstanding theoretical skepticism about the "legal" nature of international law,[31] in practice the various nations do recognize and act upon the existence of international law as possessed of "legal" force.[32]

A traditional list of sources of international law is found in Article 38 of the Statute of the International Court of Justice. This is a text of highest authority and one may fairly assume that it expresses the

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29. 15 BVerfG E 34, 16 BVerfG E 33.
30. OPPENHEIM & LAUTERPACHT, I INTERNATIONAL LAW 17 (1955).
31. *See,* Hurst, *The Nature of International Law and the Reason Why It Is Binding on States,* 3 TRANSACTIONS OF THE GROTIUS SOCIETY 119 (1945); WALZ, WESEN DES VOELKERRECHTS UND KRITIK DER VOELKERRECHTSLEUGNER (1933).
32. MENZEL, VOELKERRECHT 43 (1962).

duty of any tribunal which is called upon to administer international law.[33]

There is no international custom establishing the validity of the rule that the residence of a foreign integrated corporation is identical to that of the domestic enterprise which dominates its affairs. Many authors go even further by stating that except for the tax immunity of diplomats there are no customs in the field of international taxation at all.[34] Others challenge the existence of a custom even on the level of diplomatic tax immunity, arguing that all that exists at present may be a rule of international courtesy that may develop in the future into international custom.[35] There are no decisions of the Permanent Court of International Justice or of the International Court of Justice on the subject.

The opinions of legal writers are in conflict. Bühler,[36] in a discussion of whether or not the expansion of German tax jurisdiction disregards international law, refers to Bille and Chrétien and centers his analysis around the concept of territorial limitation of sovereignty. In his opinion, the exercise by one sovereign of his taxing power within the territory of another conflicts with the principle of sovereignty unless the taxing sovereign receives the consent of the other. Consequently, Bühler believes that the unilateral German measure which uses a fiction to convert a foreign corporation into a domestic one conflicts with the basic rule of international law — the prohibition of direct extraterritorial jurisdiction over persons within the territory of another state.

Hansel presents a contrary thesis.[37] In his opinion transnational tax jurisdiction of all states is basically unlimited by international law.

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33. BRIERLY, THE LAW OF NATIONS 56 (1963). Article 38 directs the court to apply:

a. International conventions, whether general or particular, establishing rules expressly recognized by the contesting states;
b. International custom, as evidence of a general practice accepted as law;
c. The general principles of law recognized by civilized nations;
d. Judicial decisions and the teachings of the most highly qualified publicist of the various nations, as subsidiary means for the determination of rules of law.

34. Bühler, *Les Accords internationaux concernant double imposition et l'evasion fiscale*, I RECUEIL DES COURTS, A.D.I., 458 (1936); Niboyet, *Les Doubles impositions au point de vue juridique*, RECUEIL DES COURTS 40 (1930).

35. Chrétien, *La Recherche du droit international fiscal commun* 234 (1955); Croxatto, *Die Begrenzung der staatlichen Steuerhoheit durch internationales Gewohnheitsrecht*, [1964] STEUER UND WIRTSCHAFT 879.

36. Bühler, *Grenzen des Steuerhoheit*, [1965] DEUTSCHES STEUERRECHT 398.

37. HENSEL, STEUERRECHT 14 (1927).

While there is no legal impediment for any state to expand its tax jurisdiction, it is in the interest of states to act with restraint.

Verdross adopts a more moderate view.[38] He disagrees with complete freedom from any restraint due to international law, and thinks that international law would invalidate tax jurisdiction which is not based on a minimal factual nexus between taxpayer and taxing state. However, since the principles of international law concerning transnational tax jurisdiction are wide-meshed, there is concurrent tax jurisdiction for several states under the law of nations.

Isay, on the other hand, adopts the strict theory of equivalency under which a foreigner must not be burdened by a state over and above the value of the services he receives from the taxing state.[39] He thinks, so far as legal persons are concerned, the state in which the center of administration is located has the right to general taxation. Neumeyer labels Isay's theory as pure speculation, lacking any connection with reality.[40] Finally, there is a group of authors who challenge the existence of a general international tax law as such.[41]

The decision which forms Appendix B upheld the validity of the application of § 15 II StAnpG to a foreign controlled subsidiary, despite the arguments made for declaring § 15 II invalid on the basis of international law.[42] In essence, the court said that the global taxation of a foreign subsidiary encounters no relevant objections under article 25 GG so long as the subsidiary is financially, organizationally and economically integrated into a domestic enterprise to the extent that the domestic enterprise dominates the decision-making of the legally independent subsidiary. The court also said that there is no international custom regarding this subject and questioned the existence of any custom in the field of international taxation at all.

The positions of publicists are divided and do not provide any reliable guidance. In view of this state of international affairs the opinion of the BFH hardly seems refutable. Its basic argument that it is not the legal fiction of domestic management but the economic reality of domestic integration which justifies the challenged tax jurisdiction appears defensible.

38. VERDROSS, VOELKERRECHT 248.

39. ISAY, INTERNATIONALES FINANZRECHT 48, 67 (1934).

40. NEUMEYER, INTERNATIONALES VERWALTUNGSRECHT 4, 437 (1910/36).

41. Van Hoorn, as quoted by Schulze-Brachmann, *Totalitäts oder Territorialitätsprinzip*, [1964] STEUER UND WIRTSCHAFT 590; SPITALER, DAS DOPPELBESTEUERUNGSPROBLEM BEI DIREKTEN STEUEREN 550 (1936); SCHMITZ, *supra* note 14, at 14.

42. BFH Judgment of December 18, 1963, 61s I 230, 1964 BStBl. 253.

### C. *Tax Status of Base Companies*

Rädler[43] credits Gibbons[44] with the creation of the term "base company" by his use of the expressions "base country" and "base company" in 1956. The terminology has not yet been adopted in German tax legislation or by German tax courts. German scholarly writings, however, were fast in utilizing the term "base company" while not fully agreeing as to what it meant.[45] Generally, "base companies" — in the sense used by German writers — are entities incorporated in so-called tax haven countries by domestic persons for the purpose of unjustifiable shifting of income and capital out of the home country's tax jurisdiction. "Base companies" do not include corporations, controlled by domestic persons, which have real economic functions and good business reasons for operating in tax havens.

Countries that may serve as "tax havens" are those which have no income taxes at all (Bahamas, Bermudas) or no taxes on foreign source income (Haiti, Liberia, Panama, Venezuela), and those which have holding privileges (Lichtenstein, Luxemburg, Dutch Antilles, Switzerland, Uruguay).[46] One may add to the list countries with relatively low income tax rates. In such countries, base companies (which are independent legal entities) may have income and capital not from any real business activity but as a result of shifting by the German taxpayer. The absence of taxes in Germany on these tax bases and the lack of compensating taxes by the tax haven country result in unjustified under-taxation of the parties using the base company mechanism and consequent over-taxation of parties in and revenue losses to the countries within whose respective borders the activity producing real economic gain to the base company user is carried

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43. Rädler, *Zum betriebswirtschaftlichen Begriff der Basisgesellschaft,* [1964] STEUER UND WIRTSCHAFT.

44. Gibbons, *Tax Effects on Basing International Business Abroad,* 69 HARV. L. REV. 1206 (1956).

45. Debatin, *Die internationalen Basisgesellschaften,* [1964] DEUTSCHE STEUER-ZEITUNG 9; Haas, *Die Basisgesellschaft, Manipulations — oder Integrationsform,* [1963] AUSSENWIRTSCHAFTSDIENST DES BETRIEBS-BERATERS 65; HOHENSEE, DIE BESTEUERUNG INTERNATIONAL VERPFLOCHTENER GESELLSCHAFTEN 20 (1961); Mersmann, *Die Besteuerung der verpflochtenen Gesellschaften,* 43 CAHIERS DE DROIT FISCAL INTERNATIONAL 119; VOGEL, ZUR STEUERLICHEN BEHANDLUNG ZWISCHENSTAATLICHER KAPITALINVESTITIONEN UNTER BESONDERER BERUECKSICHTIGUNG DES AUSSENSTEUERRECHTS DER BUNDESREPUBLIK 72 (1964).

46. *See* Beringe, *Recht und Besteuerung der Holdingund Basisgesellschaften in den Steueroaseniändern,* [1966] DER BETRIEB 177.

on. This result conflicts with basic principles of an equitable system of taxing international business.

### *D. Governmental Reactions to Base Company Transactions*

#### 1. Tax Haven Report.

At this time Germany has no specific base company legislation. The complexity of the issues and possible solutions involve a series of difficult considerations of economic, competitive, legal and fiscal policy. In 1962 the German Parliament, in order to acquire the requisite knowledge to enact the necessary statutes, requested that the government order a comprehensive study of all issues involved.[47] In 1964, the German government submitted to the Federal Parliament *(Bundestag)* the so-called Tax Haven Report.[48] The Report deals mainly with the alarming increase, in recent years, of foreign base company activity involving operations of companies having real economic origins in or continuing connections with the Federal Republic of Germany.[49]

The Report takes note of a great variety of corporations in tax haven countries, from those with real and substantial business activities to others which are mere letterboxes, from economically justifiable entities to clear instruments of tax avoidance, and calls attention to the types of companies especially suited for avoiding high taxes of other countries. One type consists of holding and investment companies. Property may be transferred to such companies and the income thereof may be accumulated under a favorable tax law. Another type consists of what may be called "sales intermediary" base companies. A subsidiary is interposed between buyer and seller in import or export transactions and a substantial part of the economic earnings of the domestic enterprise is artificially allocated to the controlled subsidiary. The effect is a correlative reduction of the parent's income. Further types consist of the patent administrating, personal service and other similar companies, and of special base companies which coordinate all foreign activities of the domestic enterprise.

Among the Report's proposals concerning domestic taxation of income and capital shifted abroad only those dealing with aspects of

47. Deutscher Bundestag, 4. Wahlperiode, Umdruck 75.
48. Deutscher Bundestag, 4. Wahlperiode, Drucksache IV/2412.
49. Menek, *Die Eindämmung der Steuerflucht im "Steueroasenbericht" der Bundesregierung*, [1964] DEUTSCHES STEUERRECHT 484.

personal tax liability are relevant for our discussion. As a method of subjecting tax haven property and income to domestic taxation the Report suggests that unlimited tax liability be applied in additional factual situations.[50] Similar to the proposed treatment of individuals emigrating into tax haven countries, who should continue for a certain period to be subject to unlimited domestic taxation, so also base companies as they would be defined under German law, should be taxed on their global income and capital. However, the Report makes no concrete proposal as to how the jurisdictional pattern should be shaped for this purpose.

2. *Tax Haven Ordinance*

The so-called tax haven ordinance[51] is an attempt by the government, under existing law, to prevent shifting of capital and income to tax haven countries by refusing recognition for taxation purposes to certain tainted transactions.[52] This joint ordinance of the German States, which provides control measures to prohibit tax avoidance, operates on a transaction-by-transaction basis. It allows the Revenue Services to disregard sham transactions or abuse of legal forms which aim at shifting income and capital, and to tax the domestic taxpayer as if the transaction had not taken place (§§ 1 III, 5 and 6 StAnpG). The ordinance, however, fails to deal with the problem of subjecting the base company as such to German tax jurisdiction.

3. *Residence Aspects of Base Companies*

The question whether, and to what extent, corporate residence rules may be utilized adequately to combat shifting of income and capital arises from the suggestion made in the Tax Haven Report to prevent this unjustifiable form of tax avoidance by subjecting base companies to global domestic taxation.

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50. *Id.*

51. [1965] II BStBl. 74. The administration of, *inter alia,* the personal and corporation income, as well as capital tax laws of the Federal Republic is the function of the Ministers of Finance of the various states (Länder) in the Federal Republic. The so-called "tax haven" ordinance is a joint promulgation of regulations issued by the Finanzministers of the ten states and of West Berlin to their respective directors of Revenue and their staffs to treat situations involving attempts by taxpayers to allocate income or capital to the jurisdiction of tax haven countries according to the guidelines set forth in the regulations.

52. Debatin, *Einkommens — und Vermögensverlagerungen in sogenannte Steueroasenländer unter Ausnutzung des zwischenstaatlichen Steuergefälles,* [1965] DER BETRIEB 1023, 1965.

Presently, base companies which are subjected to unlimited income and capital tax liability have a foreign seat but conduct their affairs from Germany (§§ 15 I StAnpG, 1 I KStG, 1 I VStG). An important application of this principle is, for example, the RFH decision III A 98/35.[53] The court makes it clear that the place of management is located in Germany if, in spite of the foreign seat, all significant company decisions are made by the dominant domestic person.[54] On the one hand, even if the base company has a formal head office abroad it may be subject to global German tax liability if it acts only when prompted by and according to general instructions or case-by-case directives of a German person. On the other hand, the negative implication of § 15 II StAnpG is that a mere domination of the foreign subsidiary by virtue of the financial investment of a German person is an insufficient basis for a finding that the place of management of the tax haven corporation is identical with that of the domestic parent. § 15 II covers only a subsidiary which acts like an organ of an independent entity, i.e., as an operating division of the domestic enterprise. A specific shortcoming of the otherwise far-reaching interpretation of § 15 II arises from the fact that this provision does not cover cases of foreign incorporation of private capital by private persons (i.e. the creation of holding or investment companies in a tax haven) since such cases seldom provide evidence for a finding of operational integration with a domestic enterprise.

The present German residence rules seem insufficient as an answer to the problems raised by base companies. We have mentiond the suggestion of the Tax Haven Report, but it does not spell out a solution for reaching base companies. It will probably be difficult to find an equitable and practicable way to determine which companies should be subject to the new legislation. Vogel's[55] proposal for the revision of § 15 II is indicative of the issues involved; he narrows the application of its residence rule to mere base companies in order to avoid placing German manufacturing and trading subsidiaries in a situation of competitive disadvantage.

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53. *See* Appendix A p. 240 *infra.*

54. *See* p. 243 *infra.*

55. Vogel, *Zur steuerlichen Behandlung ausländischer Einkünfte und Vermögensteile bei den Steueren vom Einkommen und Ertrag,* [1962/63] STEUERBERATER-JAHRBUCH 269.

## II. The Unilateral Rules under American Tax Law

### A. *Place of Incorporation as Corporate Residence Test and as Criterion of World-Wide Income Tax Liability*

At first glance the jurisdictional structure of the United States Internal Revenue Code (IRC)[56] seems to subject all corporations[57] of the world to the United States income tax on their world-wide every corporation and section 61(a) defines gross income as all income income. IRC section 11(a) imposes a tax on the taxable income of from whatever source derived. However, this seemingly universal approach is modified by other Code provisions.

Section 882(b) limits the initial reach of the Code by providing that in the case of a foreign corporation gross income includes only gross income from United States sources.[58] The express restriction, for foreign corporations, of sections 11(a) and 61(a) by section 882(b) does not apply to domestic corporations which remain liable to tax on their world-wide income.[59]

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56. All references are to the Internal Revenue Code of 1954, as amended.

57. The American tax concept of a corporation includes not only corporations established according to the various requirements of corporate law of the fifty states and the District of Columbia, but also a number of other forms of business association. In principle, the standards for whether or not any organization falls for tax purposes into the category of an association being taxable as a corporation, partnership or trust are determined by the Internal Revenue Code. Therefore, the term corporation in the sense of tax law is not limited to the artificial entity known as corporation; it includes moreover an association, a trust classed as an association because of its nature or its activities, a joint-stock company and an insurance company. *See* Treas. Reg. 301.7701-1(b),(c) (1960); Morrissey v. Commissioner, 296 U.S. 344 (1935).

58. The term "gross income from United States sources" or its equivalents as used in this article mean:

a. gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and

b. gross income which is effectively connected with the conduct of a trade or business within the United States.

It should be noted that the Foreign Investors Tax Act of 1966 has substantially changed the hitherto existing tax jurisdiction over foreign corporations. The taxation now applies to income from United States sources within certain specified classes (whether or not the taxpayer is engaged in trade or business in the United States) and to income from foreign sources *effectively connected* with the conduct of a United States business. A foreign corporation's income must be divided into these two categories since they are taxed at different rates. For a discussion of the Act which substantially affects the system of the United States source rules. *See* Roberts & Warren, *The Foreign Investors Tax Act, What It Covers, Whom It Affects, How It Works,* 26 J. Tax'n44 (1967).

59. Harvard Law School International Program in Taxation, World Tax Series: Taxation in the United States, 981 (1963).

A domestic corporation is a corporation created or organized in the United States or under the law of the United States or of any State or Territory (IRC sec. 7701(a)(4)). A foreign corporation is a corporation which is not a domestic corporation (IRC sec. 7701 (a)(5)).

The identification of the place of incorporation seems to be a comparatively simple operation. There are few cases or writings on the validity of the incorporation rule in the context of international taxation.[60]

### B. *Modification of the Basic System: "Indirect" Corporate Residence Rules*

According to the fundamental pattern, corporations incorporated under laws of the United States (domestic corporations) are taxed on their world-wide income whereas corporations incorporated under foreign laws (foreign corporations) are taxed only on their United States source income. This jurisdictional approach is modified for certain groups of corporations by what may be called "indirect" residence rules.

#### 1. Principles of Separation of Corporation and Shareholder and of Piercing the Corporate Veil to Prevent Tax Deferral and Avoidance

As a rule, there is a separation in the taxation of corporations and shareholders under American tax law so that first, a corporate income tax is imposed on the profits of the corporations and then second, a personal income tax is levied on the dividends received by shareholders from corporations.[61] The corporation is respected by the tax law as an independent entity separate from its shareholders. As a general matter, any reduction of taxes by taxpayers using a more favorable form for transactions is valid under tax law. In specific cases the "form" of the transaction will, however, be disregarded and the tax law will be applied to the "substance" (the economic or business

60. Abbott Laboratories International Co. v. United States, 160 F.Supp. 321 (N.D. Ill. 1958), *aff'd per curiam*, 267 F.2d 940 (7th Cir. 1959); Buckley, 22 TC 312 (1954), *aff'd*, 231 F.2d 204 (2d Cir. 1956); Arundel Corp. v. United States, 102 F.Supp. 1019 (Ct.Cl. 1952); Haussermann v. Burnet, 63 F.2d 124 (D.C. 1933); G.C.M. 9067, X-1 CUM. BULL. 337 (1931). *See* TAXATION IN THE UNITED STATES, *supra* note 59, at 1097.

61. BITTKER, FEDERAL INCOME, ESTATE AND GIFT TAXATION 592 (1964).

reality) of the situation.[62] This theory applies, for example, in the case of a sham corporation without real business purpose with the consequence that the "corporate" income will for individual income tax purposes be imputed immediately to the shareholders. In addition to such case law approaches, the United States has gone further through specific legislation.

Under the place of incorporation test all corporations incorporated under foreign law are taxed only on income derived from sources within the United States. United States taxation of the foreign income of foreign corporations owned by United States persons is therefore deferred until the receipt of the dividends by United States shareholders, who are subject to personal global jurisdiction.[63] This legal situation may create undesirable tax consequences with respect to closely held foreign corporations, chiefly because the controlling shareholders might postpone the distribution of the corporation's profits arbitrarily so that in many cases not only unreasonable deferral but in practical effect tax avoidance results.[64] Therefore, Congress has established specific sets of tax avoidance provisions applicable to domestic owners of certain foreign corporations. These rules create, in a sense, an "indirect" corporate residence concept as distinguished from the "direct" test set forth above. The pertinent areas in which deferral and avoidance have been fought by piercing the corporate veil involve "foreign personal holding companies" and "controlled foreign corporations."

a. *Foreign Personal Holding Companies.* The foreign personal holding company provisions were enacted in 1937 to remedy the specific abuse of employing foreign corporations to own portfolio investments.[65] In essence, the Code arrives at its solution as follows: under sections 551-558 IRC certain United States shareholders are subject to tax on their allocable share of the undistributed taxable income of a foreign personal holding company. A foreign personal holding company is any foreign corporation if at least sixty per cent of its gross income for the taxable year is foreign personal holding

62. Kaspare Kohn Inc., 35 B.T.A. 646 (1937); Hay v. Commissioner, 324 U.S. 863 (1945).

63. TAXATION IN THE UNITED STATES, *supra* note 59, at 1042.

64. ROSS & GUTTENTAG, UNITED STATES TAXATION OF INTERNATIONAL BUSINESS TRANSACTIONS 744 (1963).

65. The tax on non-foreign personal holding companies plays a similar role, INT. REV. CODE OF 1954, §§ 541-547.

company income,[66] and if more than fifty per cent in value of its outstanding stock is owned, directly or indirectly, by or for the benefit of not more than five individuals who are citizens or residents of the United States.[67] Foreign personal holding company income means mainly that portion of the gross income which consists of specific classes of dividends, interest payments, royalties, and annuities as well as specific categories of gains from stock and securities transactions, commodities transactions, estates and trusts, and personal services contracts.[68] The United States shareholders of foreign personal holding companies are subject to tax on their pro rata shares of the undistributed foreign personal holding company income as if this income had been distributed to them as dividends.[69] The undistributed foreign personal holding company income subject to tax is the corporation's taxable income for the year, with certain adjustments.[70] The geographic source and the character of that income are irrelevant.[71] The foreign personal holding company rules do not apply to "a corporation organized and doing business under the banking and credit laws of a foreign country if it is established to the satisfaction of the Secretary of the Treasury or his delegate that such corporation is not formed or availed of for the purpose of avoiding or evading United States income taxes which would otherwise be imposed on its shareholders."[72]

b. *Controlled Foreign Corporations.* The expansion of the original jurisdictional reach through the foreign personal holding company long-arm legislation did not eliminate the opportunity for insulation of foreign income from United States taxation provided by the device of foreign incorporation, by United States persons, of transnational business operations.[73] The Administration in 1961 proposed elimina-

66. *Id.* § 552 (a) (1).
67. *Id.* § 552 (a) (2), and § 554 (a) for constructive ownership.
68. *Id.* § 553 (a), (b).
69. *Id.* § 551 (a), (b).
70. *Id.* § 555 (a).
71. TAXATION IN THE UNITED STATES, *supra* note 59, at 1042.
72. INT. REV. CODE of 1954, § 552 (b) (2).
73. TAXATION IN THE UNITED STATES, *supra* note 59 at 1044. As to planning of the foreign business operations and selecting the most favorable form of organization under tax aspects, *see* Brudno, *Tax Considerations in Selecting a Form of Foreign Business Organization,* 1 INSTITUTE ON PRIVATE INVESTMENTS ABROAD 105 (1959); Crawford, *A Review of United States Taxation of International Operations,* 18 N.Y.U. TAX INSTITUTE 263 (1960); GIBBONS, TAX FACTORS IN BASING INTERNATIONAL BUSINESS ABROAD, (1957); Oldman, *United States Tax Law and Treaties Affecting Private Foreign Investment,* 19 FED. B.J. 345 (1959); Rado, *Foreign Corporation: Its Role in the Taxation of Income from International Trade,* 10 TAX L. REV. 307 (1955); Wender, *Use of "Tax Haven" Corporations and Western Hemisphere Trade Corporations,* [1959] U. SO. CAL. TAX INST. 253.

tion of tax deferment for operations in developed countries[74] to further United States foreign and monetary policy as well as to provide for equitable tax treatment and equal tax incentives to domestic and non-domestic investments. As finally enacted after lengthy discussions[75] the Revenue Act of 1962 dealt chiefly with tax haven operations, leaving untouched tax deferment in general.[76]

The Act subjects United States shareholders to tax on the income of controlled foreign corporations to the extent that such corporations have Subpart F income, which is mainly foreign base company income. While it is beyond the scope of this article to discuss in detail the elaborate structure of the interrelated rules,[77] a clarification of the method by which the new rules have modified the initial corporate residence test is necessary. The basic rule according to which foreign source income of foreign corporations owned by United States persons is not subject to United States tax until it is distributed as dividends to United States shareholders has been eliminated with respect to controlled foreign corporations. IRC section 951(a) eliminates this deferment of tax by requiring the inclusion in the United States shareholder's[78] gross income of the sum of his pro rata share for that year of the corporation's (1) Subpart F income, (2) previously excluded subpart F income withdrawn from investment in less developed countries and (3) increase in earnings invested in United States property.[79] Very generally, then, United States shareholders are taxed on their pro rata share of undistributed profits of controlled foreign corporations.

A controlled foreign corporation in this context is any foreign corporation of which more than fifty per cent of the total combined voting power is owned by United States shareholders on any day dur-

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74. *President Kennedy's Tax Message,* 87th Cong., 1st Sess. (1961).

75. *Hearings on H. R. 10650 Before the Senate Committee on Finance,* 87th Cong., 2d Sess. (1962).

76. As to the benefits of deferment and problems in eliminating it for the time prior to 1962, *see* OLDMAN, *supra* note 73.

77. For a discussion of Regulations under Subpart F, Revenue Service Rulings and application of sec. 482 to corporations having affiliations, *see* Slowinski, *Latest Decisions and Rulings on Controlled Foreign Corporations,* [1965] TULANE TAX INSTITUTE 358. *See also* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS at 258 *et seq.* (2d ed. 1966).

78. Defined in INT. REV. CODE OF 1954, § 551 (b).

79. *Id.* § 952 defines subpart F income; 955 defines withdrawal of previously excluded subpart F income from qualified investments in less developed countries which income while so invested is not subject to taxation under the CFC provisions; § 956 defines investment of earnings in United States property.

ing the taxable year.[80] Ownership is determined on the basis of stock held directly or owned indirectly through foreign entities or owned by virtue of the attribution rules.[81] United States shareholders are United States persons who own ten per cent or more of the total combined voting power.[82] Here, United States persons are citizens or residents of the United States, domestic partnerships, domestic corporations and any domestic estates or trusts.[83] According to this "United States shareholder" concept only ten per cent shareholders are counted in determining whether or not a foreign corporation is United States controlled, and only ten per cent shareholders are subject to current taxation.[84] The United States shareholder of a controlled foreign corporation has to include in his gross income his pro rata share of the corporation's Subpart F income for the respective year.[85] Leaving aside the technical meaning of the term Subpart F income,[86] it may be sufficient to mention that the taxed undistributed income of the controlled foreign corporation is chiefly foreign base company income which represents most of the so-called tax haven profits.[87] The three classes of foreign base company income are foreign personal holding company income, foreign base company sales income and foreign base company services income.[88]

Generally speaking, tax haven income which is attacked by the controlled foreign corporation provisions includes the "passive" income of foreign personal holding companies and the pseudo-active income earned by foreign corporations from activities involving no economic or business connection with the country of incorporation, but rather representing income shifted from a related party.[89] On the other hand, if the corporation is substantially engaged in activities which do not produce tax haven income, it is not treated as a tax haven corporation. The base company income of a given year is not subject to current tax if it is less than thirty per cent of the controlled foreign corporation's gross income. All of the controlled foreign corporation's income, however, is subject to current taxation if the aggregate base

80. *Id.* § 957 (a).
81. *Id.* § 958.
82. *Id.* § 951 (b).
83. *Id.* §§ 957 (d) and 7701 (a) (30).
84. Ross & Guttentag, *supra* note 64, at 749.
85. Int. Rev. Code of 1954, § 951 (a) (1).
86. *See* Taxation in the United States, *supra* note 59, at 1050 n. 185.
87. Int. Rev. Code of 1954, § 952 (a).
88. *Id.* §§ 954 (c), 954 (d), 954 (e).
89. Ross & Guttentag, *supra* note 64, at 750.

company income is over seventy per cent of its gross income.[90] Finally, any item of income received by a controlled foreign corporation is excluded from foreign base company income, if it is established to the satisfaction of the Secretary of the Treasury that the creation or organization of the controlled foreign corporation does not have the effect of substantially reducing income or similar taxes on said item.[91]

2. Validity of the Foreign Personal Holding Company and Controlled Foreign Corporation Provisions.

*a. Constitutional Problems.* As yet, the constitutionality of the foreign personal holding company and controlled foreign corporation provisions has not been tested in the Supreme Court,[92] although certain doubts as to their validity have been expressed.[93] One question is whether the taxation of undistributed corporate profits to the corporation's shareholders is within the income taxing power of Congress, i.e., whether this is really taxation of income.[94] The answer, in light of *Eisner v. Macomber,*[95] is not clear. In that case the Supreme Court held it beyond question that Congress has power to tax shareholders upon their property interests in the stock of corporations, valuing such interests in view of the accumulated and undivided profits of the corporation. But this would be the taxation of property because of ownership and hence would require apportionment under the provisions of the Constitution. The Court further said that the stockholder's share in the accumulated profits of the company is capital, not income, and that prior to the declaration of a dividend a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation.

If one applies the *Eisner v. Macomber* test for realization and the Court's definition of income as something proceeding from the prop-

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90. INT. REV. CODE OF 1954 § 954(b) (3).

91. *Id.* § 954(b) (4).

92. The Court did make reference to the 1937 legislation in a footnote to a dictum in Helvering v. National Grocery Co., 304 U.S. 282 (1938).

93. *See Hearings on the President's 1961 Tax Recommendations before the House Committee on Ways and Means,* 87th Cong. 1st Sess., vol. 1, at 311 (1961); *Hearings before the Senate Committee on Finance,* 87th Cong. 2d Sess. pt. 7 at 3042 (1962).

94. According to U.S. CONST. art. I, § 8, Congress shall have power to lay and collect taxes. Art. I, § 2 requires that direct taxes shall be apportioned among the several states. The Sixteenth Amendment does grant the power to Congress to lay and collect taxes on income, from whatever source derived, without apportionment.

95. 252 U.S. 189 (1920).

erty (something severed from the capital) to the taxation of shareholders on increases in undistributed net worth provided by the foreign personal holding company and the controlled foreign corporation provisions, one might conclude that the power to tax in these situations is open to challenge. On the other hand, it may be questionable to what extent *Eisner v. Macomber* is still good law, especially in view of the legislation here under consideration. The decision was five to four with Brandeis and Holmes among the dissenters. Furthermore, the Supreme Court indicated in *Helvering v. Bruun*[96] that *Eisner v. Macomber* retained validity only to distinguish ordinary dividends from stock dividends. The Court at a later date, however, did not go so far as to overrule *Eisner v. Macomber*.[97] It may also be significant that in the process of rejecting *Eisner v. Macomber* as controlling on all gross income issues the Court more recently held this case useful in distinguishing gain from capital.[98] In favor of the provisions' constitutionality is the argument that they are an exercise of congressional power to regulate commerce with foreign nations,[99] since one of the main purposes of Subpart F is to reduce the United States balance of payments deficit.[100] This gives Subpart F an additional constitutional basis, even though the Act itself makes no reference to the commerce power.[101]

An argument for the unconstitutionality of these provisions based on the due process clause of the fifth amendment to the Constitution could conceivably be made on the ground that the United States has no right to tax the foreign source income of foreign corporations even if taxation is restricted to the United States owners' share of such income. Such taxation seems particularly questionable where the foreign corporation has no business contacts with the United States. The Supreme Court has not yet defined the limits of the geographical reach of the federal taxing power. However, some inferences might be drawn from decisions on interstate taxation.[102] Here the Court

96. 309 U.S. 461 (1940).
97. Helvering v. Griffiths, 318 U.S. 371 (1942).
98. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).
99. U.S. CONST. art. I, § 8.
100. *Hearings on H.R. 10650 before the Senate Finance Committee,* 87th Cong., 2d Sess. 173-217 (1962).
101. *Hearings before the House, supra* note 77, at 319-21.
102. Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954); Scripto v. Carson, 362 U.S. 207 (1960).

ruled that there must be some definite link, some minimum connection, between the taxing state and the taxed person. A specific weakness of the due process argument is the fact that the provisions in issue do not provide for the taxation of foreign corporations as such, but rather for that of the domestic shareholder whose contact with the United States cannot be called into question.

The Second Circuit sustained the 1937 foreign personal holding company legislation and found no substantial constitutional objections, despite the argument that this statute dealt harshly with a taxpayer who was taxed on earnings forcibly retained by the law under which his foreign personal holding company was incorporated. Frank, J. noted "the Congressional purpose [to deal harshly with incorporated pocketbooks] was valid and the method of taxation was a reasonable means to achieve the desired ends."[103]

*b. Viewpoint of International Law.* Whereas German law (Art. 25 GG) treats generally accepted principles of international law as superior to domestic statutes, the United States accords international law no more than coequal status with national law as part of the law of the land.[104] Therefore, if the two laws are inconsistent, the later in time will control the earlier.[105] Consequently, from the United States' viewpoint, even if there had been a conflicting principle of international law at the time of the enactment of the foreign personal holding company and controlled foreign corporation legislation, such principles could have no impact on the validity of the domestic statutes. More generally, it is difficult to make an international legal argument against these provisions, since the required minimum contact for extraterritorial tax jurisdiction exists under two possible points of view: jurisdiction may be regarded as based either on the shareholder's domestic residence or on the foreign corporation's domestic control.[107]

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103. Eder v. Commissioner, 138 F.2d 27, at 29 (2d Cir. 1943).

104. Respublica v. De Longchamp, 1 Dall. 111 (Pa. Oyer & Term. 1784); Paquete Habana 175 U.S. 677 (1900); Barcady v. Domenech, 311 U.S. 150 (1940); Declaration of the Rights and Duties of Nations, Am. Inst. of Il, AJ 10 (1916) 212.

105. De Lima v. Bidwell, 182 U.S. 1 (1901).

107. HACKWORTH, DIGEST OF INTERNATIONAL LAW 594 (1942); HYDE, INTERNATIONAL LAW 674 (1945); NOTT, *Jurisdiction to Tax and International Income,* 17 TAX L. REV. 454 (1962).

## III. The Bilateral Rules Under the German Tax Treaties

German tax treaties are international conventions which become federal law by legislative ratification.[108] The treaty provisions then take precedence over conflicting rules of general German tax law.[109]

The purpose of tax treaties is to restrict the overlapping international taxing powers of the contracting states in order to avoid or to mitigate international double taxation.[110]

International double taxation is the imposition of the same or a similar tax on the same taxpayer with respect to the same tax base for the same period by two or more states.[111] The double tax may be caused by collisions of personal jurisdictions with different residence rules or may be due to an overlap of personal jurisdiction and source or situs jurisdiction or that of two or more source jurisdictions.

International double taxation creates large economic disadvantages[112] and undesirable legal disparities. Tax treaties with other countries play an important role in the removal of these obstacles in the interest of international transactions and relations. Since the first German treaty between Prussia and Austria in 1899[113] a growing network of conventions has developed. Twenty general tax treaties are now in force;[114] six additional treaties have been signed;[115] eleven

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108. 1 Grundgesetz art. 59.

109. RFH (1930) RStBl 556, RFH (1935) RStBl 1399. It should be noted that some question exists as to whether a tax treaty can increase the tax burden on a German taxpayer over that existing under municipal law of Germany. The tax treaty with the United States (Convention of July 22, 1954, *infra* note 155) provides expressly for avoidance of such increased tax burden.

110. Bühler, *Volkerrecht und Landesrecht im internationalen Steuerrecht,* 19 Zeitschrift fuer auslaendisches oeffentliches Recht und Voelkerrecht 689 (1958); Raedler, Die direkten Steuern der Kapitalgesellschaften und die Probleme der Steueranpassung in den sechs Staaten der Europaeischen Wirtschaftsgemeinschaft, 245 (1960).

111. Dorn, *Das Recht der internationalen Doppelbesteuergung,* [1927] Viertel-Jahres-Schrift fur Steuer-und Finanzrecht 190; Lochner, Das Internationale Doppelbesteuerungsrecht (1954); Mersmann, *Internationale Doppelbesteuerung,* 4 Handbuch der Finanzwissenschaft 91 (1965); Spitaler, Das Doppelbesteuerungsproblem bei den direkten Steuern 133 (1936). Buehler, *Internationale Doppelbesteuerung,* 1 Woerterbuch Voelkerrechts 397 (1960).

112. *See Rapport sur la double imposition,* League of Nations Doc. E.F.S./73/F/19 (1923).

113. (1900) *Preussische Gesetzessammlung* 259.

114. Treaties with the following countries: Argentina, Austria, Canada, Ceylon, Denmark, Egypt, Finland, France, Great Britain, India, Ireland, Israel, Italy, Luxembourg, The Netherlands, Norway, Pakistan, Sweden, Switzerland and The United States, *see* [1966] Der Betrieb 1665.

115. Belgium, Greece, Japan, South Africa, Spain and Thailand, *see* [1966] Der Betrieb 1665.

treaties are under negotiation.[116]

Unilateral relief from double taxation by means of tax credit[117] does not render bilateral rules unnecessary. The limitation of the source jurisdiction of the foreign country is significant if the foreign tax exceeds the parallel German tax.[118] Moreover, treaties provide an opportunity for the contracting states to balance their fiscal relationships. The international obligations thus established create a basis upon which international businessmen can reach important entrepreneurial decisions.[119]

### A. *Function of Residence in German Treaties*

The notion of residence in one of the contracting countries determines the personal reach of German tax treaties. Residence also comes into play if the country of residence grants exemption only with progression *(Progressionsvorbehalt)*, that is, when it reserves the right to consider the excluded portion of the tax base in computing the progressive rate of its tax on the non-excluded taxable portion.[120]

Residence tests for corporations under German corporate tax law[121] are modified through German treaties.[122] The modification, however, is anything but uniform.

The whole body of treaties may be divided into two major groups depending on whether the treaties use formulation of corporate residence original to the treaty,[123] or whether the treaty concept of residence

116. Australia, Brazil, Chile, Ghana, Iran, Malaysia, Mexico, New Zealand, Portugal, Syria and Turkey, *see* [1966] DER BETRIEB 1666.

117. Established for the income tax in 1957, § 34 (c) EStG, § 19 (a) KStG, and for the net worth tax in 1961 § 9 VStG.

118. It should be noted that for the most frequent case of overlapping of personal jurisdiction over residents and source jurisdiction over non-residents there are two chief methods of double taxation elimination for the country of residence if the source country retains jurisdiction with respect to stipulated items: either the exclusion of the items from the tax base or the grant of foreign tax credit, see KORN & DIETZ, DOPPELBESTEUERUNG, 6, 8, 51, 53 (Prelim. notes).

119. DORN, *Die Bedeutung des internationalen Steurrechts für das nationale Steuersystem,* [1928] STEUER UND WIRTSCHAFT 911.

120. KORN & DIETZ *supra* note 118, at 45.

121. KStG §§ 1, 2, 14 and 16.

122. RAEDLER & RAUPACH, DEUTSCHE STEUERN BEI AUSLANDSBEZIEHUNGEN 377 (1966).

123. German tax treaties with Austria, Canada, Ceylon, Egypt, Finland, India, Ireland, Italy, Luxembourg, the Netherlands, Pakistan, and Switzerland formulate a specific residence test for corporations.

The following concepts can be found:

*Seat Test*

The German tax treaties with Italy of October 31, 1925 ([1925] RGBL II 1146) and with Switzerland of July 15, 1931, ([1959] BGBl II 1253 new version) are the only ones which use the seat test as a criterion for corporate residence (Italy art. XIII (4); Switzerland art. VIII (4). Two forms of corporations of lesser importance refers expressly to the unilateral rules of the participating countries.[124]

are subject to a different test under the Swiss treaty namely, foundations and other conglomerations of property. Here the place of management is the controlling test. The seat is not defined in these treaties.

*Place of Management Test*

The conventions with Finland of September 25, 1935, ([1936] RGBL II 28) and with Pakistan of August 7, 1958, ([1960] BGBl II 1800) lay down the place of management as corporate residence standard. Article X (4) of the Finnish treaty and Article II (1) (h) of the Pakistani treaty express, as far as corporations are concerned, essentially the same thing. There is no treaty definition of the Place of Management.

*Seat or Place of Management Test*

Among the treaties establishing an original corporate residence concept only the treaty with India of March 18, 1959 ([1960] BGBl II 1828) formulates seat or place of management as alternative residence standards. According to Article II (1) (g) of the treaty a corporation has its residence in one of the contracting states if its seat is there or if its place of management is exclusively there. The treaty does not provide for a definition of the terms seat and place of management.

*Primary Place of Management, Auxilliary Seat Test*

The treaties with Austria of October 4, 1954 ([1955] BGBl II 755), Canada of June 4 ,1956, ([1957] BGBl II 187), Ceylon of July 4, 1962 ([1964] BGBl II 789), Egypt of November 17, 1959 ([1961] BGBl II 420), Ireland of October 17, 1962 ([1964] BGBl II 2661), Luxembourg of August 23, 1958 ([1959] BGBl II 1269) and the Netherlands of June 16, 1959 ([1960] BGBl II 1781) may be divided into two groups one of which takes the following approach.

Under the treaty a corporation has its residence in that treaty country where the place of its management is. If the corporation has its place of management in neither of the treaty countries, then the seat of the corporation is controlling for its residence.

This principle is modified for another group of treaties (Egypt arts. II (1) (g) and (h) 1; Ireland arts. II (1) (d) iii and IV; Canada art. II (1) (e)) insofar as the auxiliary seat test only applies if in the absence of a place of management in either treaty country the corporation has its seat in Germany (incongruent bilateral treaty test).

The treaties with Luxembourg and the Netherlands (Luxembourg art. III (6); Netherlands art. III (6)) define the place of management as the center of the top management.

124. Unlike the above discussed treaties (*See* note 123) which establish the original corporate residence concepts there is another group of German tax treaties which adopts the unilateral residence standards of the contracting countries. Into this group fall the tax treaties with Denmark of January 30, 1962, ([1963] BGBl II 1311), France of July 21, 1959 ([1961] BGBl II 397), Great Britain of November 26, 1964 ([1966] BGBl II 358), Israel of July 9, 1962 ([1966] BGBl II 329), Norway of November 18, 1958 ([1959] BGBl II 1280), Sweden of April 17, 1959 ([1960] BGBl II 1814) and the United States of December 10, 1954 ([1954] BGBl II 1117; [1965] BGBl II 1609 (Amendment)).

The reference technique varies only slightly from the language point of view depending on whether the respective treaty provisions use more or less abstract terms. In the latter case treaties (Great Britain art. II (1) h (i); Israel art. II (1) 5.a) might say, for the purposes of this treaty, the expression "a person resident in one of the two countries" means any person who, under the tax law of that country, is liable to taxation therein by reason of his domicile, abode, place of management or any other similar criterion. The other relevant treaties (Denmark art. II (1) 2.a; France art. III (1) 4.a; Norway art. II (1) 2.a; Sweden art. III (1) (a) may use the following pattern. The expression "a person resident in state x" means any person who, under the tax law of x, is a resident of x.

Treaties with original residence rules may or may not provide for an express definition of the controlling term. A further problem is the interpretation of the defined or undefined, but original, treaty concept of residence.[125]

*B. Problem of Double Corporate Residence*

Except insofar as the treaties use source rules (e.g., to determine the extent of taxation by country X of country X source income of permanent establishment in country X of a corporation of country Y), German tax treaties do not alleviate double taxation caused by an overlap of the taxing powers of two source countries. The treaties rather seek to eliminate jurisdictional collisions between the country of residence of the taxpayer claiming unlimited tax liability and the country of the source of income demanding limited tax liability. The question whether German tax treaties solve a further problem of potential international double taxation, that which exists when two states simultaneously assert worldwide tax jurisdiction on the basis of the residence of the taxed person,[126] will be examined solely from the perspective of the systematic operation of the treaties.

A different question is to what extent double residence, which results in double taxation, may arise in practice from divergent interpretation of the controlling treaty terms by the parties, even if the treaties intend to avoid such a conflict. In principle, tax treaties are

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Whereas the foregoing tax treaties adopt the unilateral corporate rules of the contracting states via a general reference to the respective non-treaty law, the German treaty with the United States makes specific references to the divergent unilateral residence tests of the contracting parties. Consequently, the treaty determines a "United States corporation" as being a corporation created or organized under the law of the United States or of any state or territory of the United States (Art. II (1) e, INT. REV. CODE OF 1954 § 7701 (a) (4). On the other hand, the treaty considers a "German corporation" as being any juridical entity having its place of management or its seat in the Federal Republic of Germany (art. II (1) f; § 1 I KStG).

125. Through practically uniform provisions the following German tax treaties have laid down this general guideline for interpretation:

As regards the application of provisions of this treaty by a contracting state any term not otherwise defined in this treaty shall, unless the context otherwise requires, have the same meaning that it has under the law of that contracting country relating to taxes in the sense of this treaty. (*See* Egypt art. II (2); Ceylon art. II (2); Denmark art. II (3); France art. II (2); Great Britain art. II (3); India art. II (2); Ireland art. II (3); Israel art. II (3); Canada art. II (2); Luxembourg art. II (2); the Netherlands art. II (2); Norway art. II (2); Pakistan art. II (2); Sweden art. III (6); the United States art. III (2)).

126. Debatin, *Der doppelte Wohnsitz im internationalen Steuerrecht,* [1966] AUSSENWIRTSCHAFTSDIENST DES BERTRIEBS-BERATERS 313.

subject to the general interpretative rules of public international law the same way as other political or economic international conventions belonging to the law of nations. However, the use in treaties of technical tax terms in order to effect reconciliation of two national tax laws involves special problems not generally found in other international agreements.

In the process of identifying the residence of a person the implementation of the treaty may become difficult if a bilateral residence concept uses a term unknown in the legislation of one contracting state, or if the expression used has a different meaning or is given a different judicial or administrative construction in one country from that which it has in the other. Problems of that sort may emerge independently of the two ways in which treaties supply a residence concept (i.e., either by way of original formulation or by way of reference to the national laws of the contracting states).[127]

Barring inconsistent interpretation of a controlling treaty term, the issue of double residence is unlikely to arise under treaties which establish an original corporate residence standard through the seat[128] and the place of management test.[129] This problem is equally unlikely to occur in treaties which formulate primarily a place of management and only secondarily a seat test.[130] In all these cases, a corporation has its residence in only one of the contracting states because the possibility of two seats or two centers of top management has been excluded by definition.

If a treaty establishes the seat and place of management as alternative criteria,[131] a corporation may have its residence in both of the contracting countries. The consequence is that the treaty does not apply to such a taxpayer and both states can in theory tax as if the treaty had not come into existence. This follows from the absence of a specific rule of preference and from the analogy to the treaty residence principle for individuals.[132]

127. Treaty with the United States art. XVII (2). *See* also, Austria art. XXI (2); Canada art. XVIII (2); Ceylon art. XIX (2); Denmark art. XXV (3); Egypt art. XX (2); France art. XXV (3); India art. XVIII; Ireland art. XXIV (2); Israel art. XXI (2); Luxembourg art. XX (2); the Netherlands art. XXV (2); Norway art. XXV (3); Pakistan art. XVII; Sweden art. XXV (2); Switzerland art. XIII (2).

128. Italy and Switzerland, note 123 *supra.*

129. Finland and Pakistan note 123 *supra.*

130. Austria, Canada, Ceylon, Egypt, Ireland, Luxembourg, and the Netherlands note 123 *supra.*

131. India note 123 *supra.*

132. According to India art. II (1) g an individual is a resident of one contracting state only if he is not a resident of the other party.

Among the German treaties which adopt the unilateral corporate residence rules of the contracting countries,[133] the double residence conflict could arise simply because of the existence of two alternative residence criteria on the German side. However, all the relevant treaties, except the international tax agreement with the United States, contain an additional provision which solves the double residence conflict by adopting a preference criterion for corporate residence. The relevant articles prescribe that a corporation which is by reason of the foregoing treaty provisions a resident of both contracting states shall be deemed to be a resident of that contracting country in which its place of effective management is located.[134]

Only the treaty with France[135] contains a definition of the place of effective management. The definition ("center of the top management") is identical with the conventional definition of "place of management" used by the treaties with Luxembourg and the Netherlands.[136]

The German tax treaty with the United States of July 22, 1954,[137] which expressly adopts the unilateral corporate residence rules of both parties, leaves open the question of double residence so that each party may exercise its unrestricted taxing power.[138] The Amendment of this treaty in 1965 did not change this point.[139]

### *C. Treaty Impact on the Unilateral Residence Fiction*

As discussed in part I, the internal German tax law has established a fiction of domestic residence for certain integrated foreign corporations, thus subjecting them to unlimited liability under German tax law. Included in this category are corporations without seat or place of management in Germany which — notwithstanding independent legal existence under private law — are in economic effect merely operating divisions of resident enterprises.

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133. Denmark, France, Great Britain, Israel, Norway, Sweden, United States note 124 *supra*.
134. Denmark art. II (1) 2.c; France art. II (1) 4.c; Great Britain art. II (1) h. (iii); Israel art. II (1) 5.c; Norway art. II (1) 1.c; Sweden art. III (1) c., note 124 *supra*.
135. Art. II (1) 5., note 124 *supra*.
136. Note 123 *supra*.
137. Note 124 *supra*.
138. KORN & DIETZ, *supra* note 118, at "United States" 12; Mersmann, *Die Ansgleichung und Harmonisierung der Steuersysteme*, [1959/60] STEUERBERATER-JAHRBUCH 45.
139. Debatin, *supra* note 126, at 315.

The question arises whether or not the residence fiction rule is applicable if the tax relations between the countries concerned are governed by treaty; most authors answer in the negative.[140] According to Vogel, § 15 II StAnpG is not good law under existing treaties for the following reasons: The unlimited tax liability of an integrated foreign corporation renders the corporation's foreign place of business a permanent establishment of the "German" enterprise. This effect, however, is contrary to the generally embodied treaty principle under which the fact that a company which is a resident of contracting country A and controls or is controlled by a company which is a resident of contracting country B shall not of itself make either company, A or B, a permanent establishment of the other in country A or B.[141] In addition, the employment of a fictitious place of management would be inconsistent with the purpose of the treaty provisions based on residence. Finally, German treaties fully recognize the corporate form; § 15 II StAnpG in effect does not. The conclusion might therefore be drawn that the residence fiction rule is excluded by tax treaties. Nevertheless, especially in the case of a treaty which adopts the unilateral residence concepts of the partner countries, the possibility exists that a German court would find § 15 StAnpG to be part of a more inclusive definition of a "German corporation." This would save both § 15 II StAnpG and the treaty.

## IV. The Bilateral Rules under the American Tax Treaties

### A. *Nature and Role of American Tax Treaties*

United States international tax conventions are treaties in a constitutional sense.[142] They are made by the President and Senate,[143]

140. Korn & Dietz, *supra* note 118, at "Vorbemerkungen" 51. Mersmann, *Die Ansgleichung und Harmonisierung der Steuersysteme,* [1959/60] Steuerberater-Jahrbuch 45, 63. Schmitz, Kommentar zum Internationalem Steuerrecht 199 (1957). Vogel, *Behandlung ausländischer Einkünfte und Vermögensteile bei den Steuern vom Einkommen und Ertrag,* [1962/63] Steuerberater-Jahrbuch 289.

141. *See* for example, France art, II (1) 7f; Great Britain II (1) 1 (vi); United States II (1) c *et seq.* (and Amendment protocol of September 17, 1965, BGBl 65 II 1609) note 128 *supra.*

142. U.S. Const. arts. I § 10, II § 2, III § 2, and VI; American Trust Co. v. Smyth, 247 F.2d 149 at 153 (9th Cir. 1957).

143. The conclusion of a treaty binding upon the United States usually involves the following stages:

First, the treaty is negotiated and signed by agents of the Executive. Then the signed treaty is submitted to the Senate for consent required by Article II, section 2, of the Constitution. After receiving that consent, the President may ratify the treaty, exchange instruments of ratification, and proclaim the treaty.

have equal authority with federal statutes[144] and regularly take precedence over existing provisions of the Internal Revenue Code.[145]

Although the United States places principal reliance in meeting the complex problems of international double taxation on the foreign tax credit system of the Code,[146] it was found necessary to supplement these unilateral measures by a network of tax treaties,[147] chiefly in order to reach mutually acceptable rules regarding the source of income, allocations of income between related enterprises and the treatment of permanent establishments.[148] Other treaty objectives may be

144. U.S. CONST. art. VI, ". . . This Constitution, and the Laws of the United States which shall be made in pursuance thereof, and all Treaties made, or which shall be made, under the authority of the United States, shall be the supreme Law of the Land, . . ."

145. Deference to foreign tax treaties is explicit in the Code. INT. REV. CODE OF 1954 § 894 provides that income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation. INT. REV. CODE OF 1954 § 7852 (d) states: "No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title [i.e., August 16, 1954]" These rules, however, are modified by the Revenue Act of 1962 which provides that the provisions of the Act take precedence over prior treaty provisions. This law is probably valid from the perspective of the domestic legal order, since the Supreme Court has clearly established the supremacy of a congressional statute which is subsequent and contrary to a treaty. *See* Chae Chan Ping v. United States, 130 U.S. 581 (1889); Edye v. Robertson, 112 U.S. 580 (1884) (the Head Money Cases); Moser v. United States, 341 U.S. 41, 45 (1951). The enactment of a later statute by Congress does not dispose of the treaty from an international point of view. Opinions of the Permament Court of International Justice stress that provisions of muncipal law cannot prevail over a treaty. *See* Greco-Bulgarian Communities, [1930] P.C.I.J. Ser. B, No. 17, at 32. Treatment of Polish Nationals in Danzig, [1932] P.C.I.J., Ser. A/B, No. 44, at 24.

146. INT. REV. CODE OF 1954 §§ 901-905. For a detailed analysis *see* E. OWENS, THE FOREIGN TAX CREDIT (1961).

147. For a discussion of the general functions of tax conventions, *see* Smith, *The Function of Tax Treaties,* 12 NAT. TAX J. 317 (1958).

148. Surrey, *International Tax Conventions: How They Operate and What They Accomplish,* 23 J. TAX'N364, 365, gives the following illustrations:

> ". . . a foreign country considers the earnings from the rendition of personal services by a U.S. individual to have its source where the enterprise paying for the services is located, while the United States considers the source to be where the services are rendered, . . . One country may regard the source of income from a sales transaction to be the place where the order is accepted. The United States considers it to be the place where title to the property passes."
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> ". . . two countries [may] utilize different methods for determining the amount of income allocable to each country from transactions between related enterprises, such as a parent corporation in one country and the subsidiary in the other country. The result may be that a segment of income is taxed in both countries, with neither giving any recognition to the tax imposed by the other. Tax treaties deal with these problems by reaching mutually acceptable rules regarding the source of income and allocations of income."

to eliminate discrimination against United States persons abroad, and to bring about consultation between tax authorities of the signatory countries. Furthermore, tax treaties may influence foreign tax rates or tax bases if the United States foreign tax credit mechanism cannot absorb the entire amount of creditable foreign taxes paid. However, one must distinguish between treaties which actually relieve international double taxation and treaties which simply reduce high foreign tax rates.[149] Although the preamble of each United States tax treaty states that the contracting countries have made the agreement to avoid double taxation,[150] the treaties play only a marginal role in that respect.[151] They change neither the world-wide jurisdictional rule for United States nationals[152] nor the fundamental tax credit sys-

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> "There are situations which may involve a combination of problems. A U.S. firm seeking to enter a market in another country may not only be confronted with the difficulties of complying with unfamiliar tax laws, but it may also be confronted with a foreign tax burden that is unrelieved by the foreign tax credit provision in our law because of differing tax concepts. The so-called permanent establishment provisions of our income tax conventions seek to cope with such cases. They describe certain types of activity which, when carried on in a foreign country by a U.S. firm, are regarded as not constituting a permanent establishment within that country, and therefore any profits earned through such activity are not taxable in that country. Thus, a firm in one country may send out salesmen to the other in an effort to penetrate a particular market without becoming subject to the tax laws of the latter country.
>
> "Other types of activities, some involving the maintenance of a definite place of business, may also be carried on without constituting a permanent establishment for tax purposes. These include such activities as a purchase of goods or merchandise, the storage of merchandise, the conduct of advertising, and the use of commission agents. This article may be of special significance in treaties with less developed countries, where it is not uncommon to assert tax on a nonresident company which sells goods to a local firm even though it is not actually engaged in business in that country."

Elizabeth A. Owens has indicated that there is some question whether most treaties accomplish resolution of conflict in the determination of the source of income, the allocations of income between related enterprises, or the treatment of permanent establishments in any meaningful fashion [Ed.].

149. OWENS, *supra* note 146, at 532.

150. The typical language is: "The Government of the United States of America and the Government of X desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion . . . have . . . agreed as follows. . . ."

151. Oldman, *supra* note 73. Owens, *United States Income Tax Treaties: Their Role in Relieving Double Taxation*, 17 RUTGERS L. REV. 428, 430.

152. With a few exceptions in which the structure of the treaty makes it unnecessary to include an express reservation, all United States tax agreements contain a saving clause reserving to the United States the right to tax nationals as if the treaty had not come into effect, *see, e.g.*, Art. XV(1) (a) of the treaty with Germany:

tem of the Code.[153]

The United States introduced the foreign tax credit system in the Revenue Act of 1918. However, it did not enter into its first general income tax treaty until 1939.[154] The United States treaty program, which grew rapidly after World War II, has already produced twenty-two treaties, twenty-one of which are still in force.[155]

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"It is agreed that double taxation shall be avoided in the following manner: The United States, in determining United States tax in the case of its citizens, residents or corporations, may, regardless of any other provision of Convention, include in the basis upon which such tax is imposed all items of income taxable under the revenue laws of the United States as if this Convention had not come into effect. The United States shall, however, allow to a citizen, resident or corporation of the U.S. as a credit against U.S. the appropriate amount of Federal Republic tax paid. . . ."

153. *Supra* note 151.

154. OWENS, *supra* note 146 at 20, Owens, *Tax Treaties, supra* note 151, at 428.

155. Treaties with the following countries aimed at preventing the double taxation of income are in force: Convention with Australia on Double Taxation, May 13, 1953, [1953] 4 U.S.T. 2274, T.I.A.S. No. 2880 (Hereinafter cited as "Australia"); convention with Austria on Double Taxation, October 25, 1956, [1957] 8 U.S.T. 1699, T.I.A.S. No. 3923 ("Austria"); Convention with Belgium on Double Taxation, October 28, 1948, as supplemented by the Protocol of September 9, 1952, [1953] 4 U.S.T. 1647, 1672, T.I.A.S. No. 2833 ("Belgium"); Convention with Canada on Double Taxation, March 4, 1942, 56 Stat. 1399, T.S. No. 983, as modified and supplemented by the Protocol of June 12, 1950, [1951] 2 U.S.T. 2235, T.I.A.S. No. 2347, and August 8, 1956, [1957] 8 U.S.T. 1619, T.I.A.S. No. 3916, ("Canada"); Convention with Denmark on Double Taxation, May 6, 1948, 62 Stat. 1730, T.I.A.S. No. 1854 ("Denmark"); Convention with Finland on Double Taxation, March 3, 1952, [1952] 3 U.S.T. 4485, T.I.A.S. No. 2596; Convention with France on Double Taxation, July 25, 1939, 59 Stat. 893, T.S. No. 988, modified and supplemented by protocols of October 18, 1946, 64 Stat. B3, T.I.A.S. No. 1982, May 17, 1948, [1957] 8 U.S.T. 843, T.I.A.S. No. 1982, and June 22, 1956, [1957] 8. U.S.T. 843, T.I.A.S. No. 3844 ("France"); Convention with Germany on Double Taxation, July 22, 1954, [1954] 5 U.S.T. 2768, T.I.A.S. No. 3133, as modified by the Protocol of September 17, 1965, [1965] 16 U.S.T. 1875, T.I.A.S. No. 5920 ("Germany"); Convention with Greece on Double Taxation, February 20, 1950, [1954] 5 U.S.T. 47, T.I.A.S. No. 2902 ("Greece"); Convention with Ireland on Double Taxation, September 13, 1949, [1951] 2 U.S.T. 2303, T.I.A.S. No. 2356 ("Ireland"); Convention with Italy on Double Taxation, March 30, 1955, [1956] 7 U.S.T. 2999 ("Italy"); Convention with Japan on Double Taxation, April 16, 1954, [1955] 6 U.S.T. 2999 ("Italy"); Convention with Japan on Double Taxation, April 16, 1954, [1955] 6 U.S.T. 149, T.I.A.S. No. 3176, as modified and supplemented by the Protocols of May 7, 1960, [1964] 15 U.S.T. 1538, T.I.A.S. No. 5637 and August 17, 1962, [1965] 16 U.S.T. 697, T.I.A.S. No. 5798 ("Japan"); Convention with Luxembourg on Double Taxation, December 18, 1962, [1964] 15 U.S.T. 2355, T.I.A.S. No. 5726 ("Luxembourg"); Convention with the Netherlands, April 29, 1948, 62 Stat. 1757, T.I.A.S. No. 1855 ,as modified and supplemented by the Protocol of October 23, 1963 [1964] 15 U.S.T. 1900, T.I.A.S. No. 5665 ("Netherlands"); Convention with New Zealand on Double Taxation, March 16, 1948, [1951] 2 U.S.T. 2360, T.I.A.S. No. 2360, as modified and supplemented by the Protocol of July 10, 1958, [1959] 10 U.S.T. 1924, T.I.A.S. No. 4360, ("New Zealand"); Convention with Norway on Double Taxation, June 13, 1949, [1951] 2 U.S.T. 2323, T.I.A.S. No. 2357 ("Norway"); Convention with Pakistan on Double Taxation, July 1,

### *B. Function of Residence in American Treaties*

Since international income tax jurisdiction is based on the two fundamental factors of residence and source, the concept of corporate residence also serves as an indispensable structural element in the bilateral jurisdictional assertions of the United States.

First, corporate residence, the status of a corporation as a "national", for tax purposes, of any one of the contracting countries, is the basis for the personal scope of the treaties.[156] Once the treaty reaches juridical persons of the partner countries, the "residence" concept is of fundamental importance in defining the taxpayers with respect to which one country and not the other will be the tax-collecting sovereign, and the extent to which income will be subject to tax by either the country of residence or by the other treaty partner.[157]

### *C. The Distinct Treaty Concepts of Corporate Residence*

A comprehensive view of the United States' bilateral corporate residence rules reveals that no treaty abandons — for determination of United States "residence" — the unilaterally controlling place-of-in-

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1957, [1959] 10 U.S.T. 984, T.I.A.S. No. 4232 ("Pakistan"); Convention with South Africa on Double Taxation, December 13, 1946, [1952] 3 U.S.T. 382, T.I.A.S. No. 2510, ('South Africa"); Convention with Sweden on Double Taxation, March 23, 1939, 54 Stat. 1759, T.S. No. 958, as modified and supplemented by the Protocol of October 22, 1963, [1964] 15 U.S.T. 1824 T.I.A.S. No. 5656, ("Sweden"); Convention with Switzerland on Double Taxation, May 24, 1951, [1951] 2 U.S.T. 1751, T.I.A.S. No. 2316 ('"Switzerland"); and Convention with the United Kingdom on Double Taxation, April 16, 1945, 60 Stat. 1379, T.I.A.S. No. 1546 as modified and supplemented by the protocols of June 6, 1946, 60 Stat. 1389; T.I.A.S. No. 1546, May 25, 1954, [1955] 6 U.S.T. 37, T.I.A.S. No. 3165, August 19, 1957, [1958] 9 U.S.T. 1329, T.I.A.S. No. 4124 ("United Kingdom"). A treaty with Israel was signed June 29, 1965. The treaty with Honduras of June 25, 1956, [1957] 8 U.S.T. 219, T.I.A.S. No. 3766, was terminated December 31, 1966.

156. "Personal scope" means the reach of the treaty, *i.e.*, its applicability to certain juridicial persons. Thus, for example, the treaty with Germany, *supra* note 155, in article III(1), under certain circumstances, exempts "industrial or commercial profits *of an enterprise of one of the contracting States*" (emphasis added) from tax by the other contracting State. Whether the treaty is applicable to any particular taxpayer thus depends on whether the taxpayer is a juridical person which the treaty reaches, *i.e.*, whether the taxpayer is "an enterprise of one of the contracting states." This question must be answered before a decision can be reached whether the juridical person has met the other conditions which make the treaty's substantive provisions (*e.g.*, relief from liability for certain taxes) applicable.

157. *See, e.g.*, Germany art. II(d), (e), (f) (providing the residence rules) and art. III *et seq.* (applying the residence rule in allocating jurisdiction to tax certain income from specified entities to one or the other treaty partner country).

corporation test established by section 7701(a)(4) of the Code.[158]

Even though all but one of the conventions establish the corporate residence test for both sides (and that one exception establishes the test for one side),[159] none of the conventions defines its residence concepts. Thus the treaty rule, that in the application of the treaty by one of the contracting States the respective residence term has the meaning which the term has under that State's national tax law, becomes relevant.[160]

### *D. The Problem of Double Corporate Residence*

The corporate residence can best perform its fundamental function within the structure of an international tax convention either if the residence rule itself makes double residence impossible, or if a treaty preference criterion actually determines the country of residence and thus resolves a potential conflict of two simultaneous residences.

In the United States tax conventions, the problem of double corporate residence cannot arise in the many treaties which establish a congruent test of place of incorporation for both countries.[161] The same corporation cannot be created or organized at the same time in more than one state.

158. In the entire body of American treaties there is one group of conventions which uses for the same purpose a somewhat shorter language ("Created or organized in or under the laws of the United States") than the code ("Created or organized in the United States or under the law of the United States or any State or Territory"). *See* Australia art. II(1)(g); Greece art. II(1)(c); India art. II(1)(g); Ireland art. II(1)(h); Pakistan art. I(1)(h); United Kingdom art. II(1)(h); *see supra* note 155.

159. The convention with Australia is the only one in the United States tax treaty series which does not establish express residence concepts for both contracting countries. Rather, the term "resident of Australia" is given that meaning which it has under the laws of Australia relating to Australian taxation. Australia art. II(1)(h). *See supra* note 155.

160. All United States tax conventions contain such a rule, *see, e.g.,* Australia art. II (2); United Kingdom art. II(3).

161. United States tax conventions with Austria, Belgium, Canada, Denmark, Finland, France, Italy, Japan, the Netherlands, Norway, Sweden, Switzerland and the Union of South Africa establish congruent place of incorporation tests for both treaty partners. A corporation is deemed to be a resident of one of the contracting states if it is created or organized in or under the laws of that state (or the laws of its states, territories or provinces). *See* Austria art. II(1)(d) and (e); Belgium art. II(1)(c) and (d); Canada Protocol 1.(d) and (e); Denmark art. II(1)(f) and (g); France Protocol III(d) and (e); Italy art. II (1)(f) and (g); Japan art. II(d), (e) and (f); the Netherlands art. II(1) (c) and (d) (the language here is "created . . ." instead of the constant form "created or organized . . ."); Norway art. II(1)(f) and (g); Sweden Protocol 1. (d) and (e); Switzerland art. II(1)(e) and (f); South Africa art. II(c); *supra* note 155. The tax convention with Greece seems to reach the same result. A "Greek corporation" is defined as one "established under the laws of Greece." *See* Greece art. II(1)(d).

In treaties using non-congruent corporate residence criteria the double residence problem may arise, since a corporation may be a United States corporation by virtue of incorporation under the laws of the United States while, at the same time, it may be a corporation of the other country which is party to the treaty by virtue of management and control of its business from this second country,[162] or by virtue of location of its seat or business management in the second country.[163]

Of the United States treaties which are vulnerable to a possible double-corporate-residence problem none establishes a preference criterion for determining in which of the two states the corporation resides. Rather, these conventions either pass the question over in silence, thus preventing treaty provisions for which a "one corporation, one residence" situation is necessary from being applied in practice, or they reach the same result by explicit exclusionary provisions. The wording may vary from treaty to treaty, but in essence the approach is as follows: The term "resident of the State X" means any person (other than a citizen of State Y or a Y corporation) who is resident in X for purposes of X tax law and not resident in Y for purposes of Y tax law.[164] Conversely, the same formula usually applies to a "resident of the State Y."

Since U. S. income tax treaties play such a marginal role in relieving double taxation, it can be contended that only matters of detail and definition are left for bilateral resolution through tax conventions. In those treaties which either provide non-congruent residence rules, or which leave the residence concepts of the countries which are party to the treaty applicable under the treaty, or which provide a congruent treaty concept of residence, the supposed definition of which

162. India art. II (1) (h); Ireland art. II (1) (g); Pakistan art. II (1) (i); United Kingdom art. II (1) (g). The treaty with New Zealand lays down the rule that a corporation is to be deemed a resident of New Zealand if it is incorporated under the laws of New Zealand or if its business is managed and controlled in New Zealand. No other United States Convention takes such an approach. *See* New Zealand art. II (1) (j); *supra* note 155.

163. The treaties with Germany and Luxembourg establish that the terms "German company" and "Luxembourg corporation" mean a juridical person, together with an entity as a juridical person for tax purposes under the laws of the respective state, if such a person or entity has its business management or seat in the respective country. *See* Germany art. II (1) (f) and Luxembourg art. II (1) (e), *supra* note 155.

164. Australia art. II (1) (f) and (g); India art. II (1) (g) and (h); Ireland art. II (1) (g) and h); Luxembourg art. II (1) (d) and (e); New Zealand art. II (1) (j) and (k); Pakistan art. II (1) (h) and (i); and the United Kingdom art. II (1) (g) and (h); *supra* note 155.

is so general that it leaves open the possibility of non-congruent interpretation and application of the express residence concept under the differing municipal laws of the treaty partners, the treaties may have failed in one of the few important tasks which can be accomplished only by international agreement, that of reconciling differences in definitions which may cause double taxation no matter how generous unilateral relief granted by the treaty partner countries may have been. The question may then be asked whether the cost, in terms of revenue and added complexity of the treaty program, justifies its benefits to the partner countries and to their taxpayers.[165]

## V. Comparative Analysis

### A. *Main Characteristics of the American and German Approaches*

#### 1. Unilateral Principles

Except in unusual circumstances,[166] both the United States and Germany assert world-wide tax jurisdiction over domestic corporations and tax foreign corporations only on their domestic sources.

However, the controlling criteria of residence are different in each country. In the United States, incorporation is the sole test of residence, whereas in Germany two independent standards are applied, namely, seat or place of management. Both the German concept of seat and the American notion of incorporation are determined by elements of formal law, and neither test has undergone extensive judicial elucidation.[167]

The German principle of taxing foreign corporations only on their domestic income and capital has been radically modified for certain integrated foreign corporations. Legally independent corporations with seat or place of management abroad are treated as if they were domestic corporations. They are thereby subject to world-wide taxation, provided they are financially, economically and organizationally integrated into a domestic enterprise. This statutory fiction has been challenged on grounds of constitutional and international law. How-

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165. *See* generally Owens, *supra* note 151.

166. Certain Canadian and Mexican corporations are treated as domestic rather than as foreign corporations for purposes of the United States income tax. *See* Taxation in the United States, *supra* note 59, at 1098 and n. 278.

167. *Supra* note 60.

ever, the Supreme Finance Court, in a very thorough opinion, has affirmed the validity of the "long-arm" legislation.

Indirect corporate residence rules have changed fundamentally the United States' basic jurisdictional approach to foreign corporations and domestic owners of foreign corporations. It is true that foreign personal holding companies and controlled foreign corporations are not treated directly as if they were domestic residents, but specific provisions reach them in fact by subjecting the controlling American shareholders to taxation on "their" undistributed profits.

Germany still lacks specific legislation against the use of "incorporated pocketbooks" and base companies in "tax havens" but is attempting to combat them by, *inter alia,* broadening the application of its direct residence rules.

2. Bilateral Rules

Both the United States and Germany have produced a considerable and still growing network of international tax treaties, the provisions of which regularly take precedence over conflicting "internal" tax law. However, the jurisdictional role of the treaties is essentially different in both tax systems. The German conventions typically serve the purpose of relieving international double taxation through actual restriction of the overlapping unilateral assertions of different tax sovereignties. The United States treaties play only a marginal role in this respect; as a rule all American conventions contain a saving clause which reserves to the United States the right to tax its citizens, residents and corporations as if the treaty had not come into effect. In meeting the problems of international double taxation the United States — treaties notwithstanding — places principal reliance on the foreign tax credit system of the Internal Revenue Code.

### *B. Historical Roots and Legislative Reasons*

The fundamental difference between the principles of corporate tax residence in the two countries must be explained. This discussion seeks to penetrate the historical background of the original unilateral rules.

1. United States

The Revenue Act of 1894[168] provided for taxation of both individ-

168. 28 Stat. 553.

uals and corporations. After this Act was declared unconstitutional in *Pollock v. Farmers' Loan and Trust Co.*,[169] the Tariff Act of 1909,[170] providing for taxation of the privilege of doing business as a corporation in the United States, was passed. Income was used merely to measure the value of the privilege.[171] The actual direct tax on corporate net income, constitutional by virtue of the Sixteenth Amendment, was introduced by the Revenue Act of 1913.[172]

As for the test of "domestic" and "foreign" corporations, the concept of place of incorporation has been in effect continuously since the Tariff Act of 1909, notwithstanding some changes in the wording.[173] Compared with this, the Revenue Act of 1894 taxed all corporations doing business for profit in the United States, no matter how they were created and organized.[174]

The question as to why the United States originally adopted the place of incorporation as the controlling test is not explicitly answered in the legislative materials.[175] The existence of a clear rationale or of a conscious policy behind the adoption of this principle is doubtful, in light of the state of taxation and tax legislation prior to the develop-

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169. 157 U.S. 429 (1895).
170. 36 Stat. 112.
171. Flint v. Stone Tracy Co., 220 U.S. 107 (1911).
172. 38 Stat. 172.
173. a. Tariff act of 1909, *supra* note 170, at § 38: ". . . every corporation . . . now or hereafter organized under the Laws of the United States or of any State or Territory of the United States or under the acts of Congress applicable to Alaska or the District of Columbia . . . shall be subject to pay . . . with respect to the carrying on or doing business by such corporation . . ."
    b. Revenue Act of 1913, *supra* note 171, at § 11 G(a): ". . . upon the entire net income . . . accruing . . . to every corporation . . . organized in the United States ,no matter how created or organized . . . but if organized, authorized or existing under the laws of any foreign country . . ."
    c. Revenue Act of 1917, 40 Stat. 302, Title II, Sec. 200: "The term 'domestic' means created under the Laws of the United States, or of any State, Territory or District thereof and the term 'foreign' means created under the law of any other possession of the United States or of any foreign country or government."
    d. Revenue Act of 1918, 40 Stat. 1058, Title I, Sec. 1: "The term 'domestic' when applied to a coporation . . . means created or organized in the United States. The term 'foreign' when applied to a corporation . . . means created or organized outside the United States."
174. Revenue Act of 1894, *supra* note 168, at § 27.
175. H.R. REPORT No. 1, 61st Cong., 1st Session (1909). H.R. REPORT No. 20, 61st Cong., 1st Session (1909).

ment of more sophisticated modern tax law.[176] More likely, Congress simply borrowed corporate residence criteria from other areas of federal law or from tax laws at the state level.

The notion of congressional "borrowing" of residence criteria from the state level is supported by the manner in which the power to tax corporations was allocated by different states in the nineteenth century. Although not all systems of state taxation can be examined here, the corporate residence tests of a remarkable number of industrially prominent states may have served as models to Congress when it established national tax jurisdiction. Massachusetts,[177] Connecticut,[178] New York,[179] New Jersey,[180] Pennsylvania,[181] Ohio,[182] Indiana,[183] Michigan,[184] Illinois,[185] and Wisconsin[186] had adopted the place-of-incorporation test for distinguishing "domestic" from "foreign" corporations.

In discussing possible reasons for the formulation of the basic criterion for personal corporate tax jurisdiction one must also consider the general economic background of the respective legislation. The need for logical and well-devised international tax rules depends on the degree of a state's participation in international business transactions. In view of the fact that American corporations with overseas interests at the time of the adoption of the international tax residence rules played not nearly as important a part in the country's economy as the modern multinational corporations, structural problems of a proper

176. The situation of that time is described by the Controller of New York commenting in his report for 1898 on the "confused, illogical and conflicting" condition of the tax laws of New York: "Investigation shows that they have been largely adopted, from time to time, simply to meet the increasing expenditures of the State, with little regard to economic or any just and equitable principle. They were framed rather in accord with the witty Frenchman's definition of taxation, 'the plucking of the goose in such manner as to get the most feathers with the least squawking'. In a word it must be confessed that nearly all our taxes are legislative makeshifts and many of them blunders." *See* CLAPPERTON, TAXATION OF CORPORATIONS 36 (1901).

177. CLAPPERTON, *supra* note 176, at 14. ". . . chartered or organized under the laws of the State . . ."

178. *Id.* at 33. "chartered/organized . . .."

179. *Id.* at 40, 41. ". . . organized . . .."

180. *Id.* at 51. ". . . incorporated . . .."

181. *Id.* at 61, 62. ". . . incorporated . . .."

182. *Id.* at 76. ". . . incorporated . . .."

183. *Id.* at 93. ". . . incorporated . . .."

184. *Id.* at 105. ". . . organized . . .."

185. *Id.* at 122. ". . . incorporated . . .."

186. *Id.* at 140. ". . . organized . . .."

personal international tax jurisdiction could scarcely have been of principal legislative concern.

If — an acceptance of residence concepts already established elsewhere aside — there exists any rationale at all for the place-of-incorporation test it might possibly have been a consideration of equal tax treatment for those equally situated, *i.e.* not unlike what is today called "horizontal equity" in its broadest sense. It is conceivable that Congress believed only United States citizens or individual residents would incorporate their business activities in the United States and in the United States alone.

So far as the equation of citizen and domestic corporation is concerned, the place-of-incorporation test also has traditional roots in American non-tax law. The courts, beginning with the early nineteenth century, developed this criterion of corporate status especially to differentiate between "citizens" and "non-citizens" in restrictive statutes.[187]

2. Germany

The history of the taxation of corporate income reaches back to the tax statutes of the German States under the *Kaiserreich* (Imperial Germany).[188] The *Reich* itself had no power to tax income, whereas all States with the exception of Mecklenburg and Alsace-Lorrain had established general income tax laws.[189] The Prussian Income Tax Law of 1891 grew to be of special significance for the development of corporate taxation in Germany; its great innovation was the personal tax liability of corporations.[190] When it obtained the taxing power after World War I, the *Reich* in 1920 regulated the income taxation of corporations through a separate corporate income tax law,[191] which is still in effect despite a certain number of modifications.[192]

187. Vagts, *The Corporate Alien: Definitional Questions in Federal Restraints on Alien Enterprise,* 74 HARV. L. REV. 1526 (1961).

188. PETERS & HERRMANN, 1 KOMMENTAR ZUR EINKOMMENSTEUER UND KOERPERSCHAFTSSTEUER, *Einführung* (Introduction).

189. EHEBERG, FINANZWISSENSCHAFT (1911).

190. Wagner, *Die Reform der direkten Staatsbesteuerung in Preussen im Jahre 1891,* [1891] FINANZARCHIV 551-810.

191. Corporate Tax Law of March 30, 1920, [1920] REBl 393.

192. Corporate Tax Law of March 26, 1921 [1921] RGBl 342.
Corporate Tax Law of April 8, 1922, [1922] RGBl 472.
Corporate Tax Law of August 10, 1925, [1925] RGBl 208.
Corporate Tax Law of October 16, 1934, [1934] RGBl 1031.
Corporate Tax Law of September 5, 1949, [1949] WiGBl 311.
As for a list of further post-war amendments *see* PETERS & HERRMAN, *supra* note 188 at chapter 23.

The combination of seat or place of management as independent criteria of corporate tax residence was first established in the Corporate Tax Law of 1920.[193] The seat test, as can be seen from the tax statutes of Prussia, Bavaria, Saxony, Württemberg and Hesse[194] was not new to German tax law at that time. The place of management standard, however, seems to have no predecessors in German state statutes. The reason behind the adoption of the place of management concept is not expressed in the legislative materials,[195] but might lie in a general trend of replacement of "citizenship" with "residence" as the basis for personal tax liability. According to Hensel,[196] in exercising its new taxing power and in establishing the jurisdictional basis, the *Reich* gave up the personal tie of citizenship in favor of the economic-territorial connection to determine those liable under its tax laws. The place of management criterion comes close to this notion so far as corporations are concerned. Besides, the emphasis on the economic-territorial nexus of a person to a state is not unique under German transnational law.[197] The *Sitz der Hauptverwaltung* in private international law, for example, is a somewhat similar though not identical concept of a corporation's contact to a state.[198]

The legislative purpose in the adoption of the residence fiction rule for integrated foreign corporations cannot be misunderstood. This expansion, in the Corporate Tax Law of 1934, of the basic jurisdictional test found in the Corporate Tax Law of 1920 represents an attempt to prevent tax avoidance by internationally operated business combines.[199] The government intended to achieve equal tax treatment of two categories of taxpayers deemed to be equal: domestic enterprises doing business abroad directly or through a foreign permanent establishment on the one hand, and domestic enterprises having incorporated their respective foreign activities abroad without proper business reasons on the other. The Act of 1934 sought to pierce the corporate form of organizations of the second variety be-

193. *See* KStG § 1 (2).

194. *See* EHEBERG, *supra* note 193. Prussia, Statute of June 24, 1891, 289 ("seat"); Bavaria, Statute of August 14, 1910, 291 (like Prussia); Saxony, Statute of June 2, 1897, ("seat") [1898] FINANZ-ARCHIV 355; Württemberg, Statute of August 8, 1903, 293 (like Prussia); Hesse, Statute of August 12, 1899, 294 (like Prussia).

195. *See* Reichstagsdrucksache No. 1976 of January 16, 1920, at 21.

196. STEUERRECHT, 66 (1933).

197. KEGEL, INTERNATIONALES PRIVATRECHT 206 (1964).

198. *See* p. 223 *infra*.

199. PETERS & HERRMANN, *supra* note 188, at § 1 n.8.

cause they lacked economic substance and independence.[200]

### C. *Policy Considerations for Corporate Residence Concepts*

The previous discussion sought to explore and explain the state of American and German law. How the law should or could be presents a different problem.

#### 1. Significance of a Proper Residence Test Under a Personal and Global Tax Jurisdiction.

The impact of the rule of residence depends upon the extent to which a country gives to its tax law a transnational scope. Residence as jurisdictional contact is of minor interest for tax systems which adhere to the principle of territoriality, and thus do not tax their taxpayers on income from foreign sources.[201] On the other hand, the issue of residence is of central significance for all countries that tax their residents on a global basis.[202] Such countries necessarily encounter the complex problems of basing their world-wide jurisdictional approach on a notion of residence which reflects adequate connections between taxpayer and taxing power. The United States and Germany, as well as other industrialized countries with developed tax laws, base their global approach of taxation on the concept that the income tax is a personal tax. Therefore, they focus on the person and his ability to pay, no matter whether the person is an individual or a legal entity and notwithstanding the character and the geographic source of the income.[203] The underlying idea is that income tax is a tax on a per-

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200. *Official Report of the Reichsregierung,* [1934] RStBl 1410.

201. According to United Nations references the following countries belong to this group: Argentina, Costa Rica, Dominican Republic, El Salvador, Guatemala, Haiti, Nicaragua, Panama, Uruguay, South Africa and Venezuela.

202. The "global v. territorial" jurisdiction antithesis is not identical with the "residence v. source" antithesis. The latter reflects the following basic controversy of international tax law. What country has, from a policy point of view, a prior right to tax income? The country from which the income is derived (source principle) or the country with which the owner of the income is personally connected (residence principle)? For a discussion of this question *see,* BUEHLER, PRINZIPIEN DES INTERNATIONALEN STEUERRECHTS at 181-193 (1964). For an historical analysis *see,* RICHMAN, TAXATION OF FOREIGN INVESTMENT INCOME 37-46 (1963).

203. Some reasons supporting a personal jurisdiction are: Avoidance of inequitable and discriminatory treatment among taxpayers with equal ability to pay; avoidance of undesirable capital investment abroad at the expense of investment at home; tax neutrality of international capital flow; realization of the revenue potential of foreign income; avoidance of administrative and judicial difficulties created by the manipulating of source rules.

son's income, irrespective of type of income.[204] The person is the central figure within this global jurisdictional pattern. To create a fair and efficient tax system of this sort, one must define the controlling personal status on which the tax law can be based.

The difficult task of devising adequate residence rules based on the personal status of corporate taxpayers presents the policy planner with the question of what circumstances give the corporation sufficient personal contact with a state which taxes globally. What equitable, politically expedient, economically desirable, and administratively feasible factors and elements form a rational and substantial link?

It may be useful to an exploration of the various aspects of the problem to provide some general background on the personal status of corporations in areas other than tax law.

2. Non-Tax Notions of Corporate Connections with States.

*a. Diplomatic Protection of "National" Corporations.* There is wide agreement that a state is entitled to tax income and capital of persons whose duties to the state are matched by their rights to the protection and services of the state.[205] Assuming that the exercise of personal tax jurisdiction can be viewed as correlative to a state's grant of diplomatic protection,[206] the question is how the international community treats corporations in this respect. Factors which are regarded as sufficient connection with a state so that the state will consider the claims of a juridical person as if it were a national of that state might have some weight when one seeks workable corporate links with the state as a basis for taxation, by such state, of the corporation's international business operations and income.

The orthodox diplomatic view which dates from the period when corporations began to act in multinational life is expressed in the *Mexico Plantagen* case.[207] The decision holds that a corporation can have nationality and that its nationality is that of the state under whose laws it was established. The Chairman stated,

> No plausible reason can be conceived for limiting nationality only to natural persons. A company is a person created

204. SIMMONS, PERSONAL INCOME TAXATION 128 (1938).
205. KELSEN, THE GENERAL THEORY OF LAW AND STATE 75 (1946).
206. It is elementary international principle that a state has the right to protect its subjects when injured by acts contrary to international law committed by another state, *see* Case of the Mayromatis Palestine Concessions, [1924], Ser. A, No. 2.
207. [1931-32] Ann. Dig. (No. 135) (German-Mexican Claims Commission, January 25, 1930).

> by the law, owing its existence to a contract which, entered into in accordance with legal forms in effect in the State in which it is created, renders it capable of acquiring rights and assuming obligations like a natural person. Thus, just as a natural person is tied to the State by nationality acquired through birth or naturalization, a tie from which rights and duties are derived, so a company is tied to the state in whose territory it is created and acquires rights and obligations.

In line with the *Mexico Plantagen* theory, foreign offices and tribunals acknowledged only a very limited right of a state to represent its natural shareholders in a foreign corporation.[208]

This rather formal view of corporate nationality or presence has, however, been gradually abandoned, and a more realistic approach (from the viewpoint of diplomatic protection) to the problems of a corporation's affiliations with different sovereign states has been adopted. In *Mexico Plantagen* the Chairman rejected the idea that a corporation has the nationality of its members or the nationality of the place of its domicile or *siege social.* In the meantime diplomatic practice has given increased attention to the shareholder and his nationality. The United States, for example, in distributing lump-sum settlements (obtained from other nations) to American nationals, will generally consider a claim on behalf of corporations organized within the United States only if fifty per cent or more of their stock is owned by United States citizens.[209] Conversely, the United States will consider claims on behalf of foreign corporations only if "citizens of the United States have or have had a substantial and bona fide interest" in such corporation.[210] At one time this meant that at least 25 per cent of the beneficial interest of the corporation had to be owned by American citizens.[211] This standard evolved from situations in which bilateral settlement agreements frequently required that a certain percentage of shares in a corporation organized in the state against which the claims existed be owned by nationals of the claimant state

208. *See* Romano-American Claim, 5 H. ACKWORTH, DIGEST OF INTERNATIONAL LAW, 840-43 (1943). For a statement of Great Britain's view: United States v. Germany, *Id.* at 833 (Mixed Claims Commission 1939).

209. LILLICH & CHRISTENSON, INTERNATIONAL CLAIMS: THEIR PREPARATION AND PRESENTATION, 88-89 (1962).

210. *Id.* at 90.

211. *Id.* at 92-94; Act of Aug. 9, 1955, Pub. L. No. 285, Ch. 645, 69 Stat. 562 (1955).

before a claim could be brought before the latter state's claims commission.[212]

*b. Corporate "Alienage" under Restrictive Statutes.* Similar to the problems which arise in a consideration of the diplomatic protection of national corporations are those presented by commercial restrictions on alien persons and corporations.

The place of incorporation is not insignificant; in fact, it may be decisive. But taken separately or together, the following factors also can be used as possible tests: the nationalities of shareholders, directors, holders of debt capital, and owners of patents and trademarks employed by the corporation and the nation in which the business activities or the direction of the corporation are centered.[213] The distinction between domestic and foreign corporation, necessary to a discussion of diplomatic protection, appears more uniform than that which is found in a consideration of the United States' restrictions on alien commercial activities. The reason may be that "nationality" requirements — of necessity — vary considerably according to the different activities involved.[214]

*c. Choice of Law Approaches to "International" Corporations.* The above section presents some non-fiscal concepts of corporate nationality which arise in private international law. A brief look at the legal classification of corporations in the choice-of-law area might supplement the picture. In Anglo-American jurisdictions, the law of the state of incorporation is referred to on questions which pertain to the internal affairs of corporations engaged in multistate or multinational activities. This principle provides a high degree of certainty and predictability, since the controlling legal system is relatively simple to identify. However, it has been modified in particular cases by the concept that the law of the state with which the corporation is signifi-

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212. *See, e.g.,* Annex to the Agreement between the United States and Poland, July 16, 1960, [1953] 2 U.S.T., T.I.A.S. No. 4545. For a further discussion see: DeVisscher, *La Protection Diplomatic des Personnes Morales,* [1964] RECUEIL DES COURS 339 (Hague Academy of International Law); Jones, *Claims on Behalf of Nationals Who are Shareholders in Foreign Corporations,* 34 BRIT. Y.B. INT'L L. 192 (1958).

213. *See e.g.,* law of Washington relevant to Terrace v. Thompson 263 U.S. 193 (1923); law of California relevant to Takahashi v. Fish and Game Commission, 334 U.S. 410 (1948); Sec. 310 (a) Communications Act of 1934 relevant to Noe v. Federal Communications Commission, 260 F.2d 739, (D.C.Cit. 1958).

214. For a general overview of this area, *see* Vagts, *The Corporate Alien: Definitional Questions in Federal Restraints on Alien Enterprise,* 74 HARV. L. REV. 1489 (1961).

cantly linked governs rather than the law of the state of incorporation with which the corporation may have minimum contact.[215]

This approach reflects, in part, the European concept of the "personal law" of corporations. In principle, courts of civil law countries refer to the country of the *siege social* (France) or the *Sitz der Hauptverwaltung* (Germany), not to the state of incorporation or the country where the head offices are registered.

*Sitz der Hauptverwaltung* means in essence the principal place of business of the corporation. This is thought to be a more adequate test of a corporation's connection with a country for choice-of-law purposes than the formal seat or place of incorporation.[216]

The concept of *siege social* comes close to the notion of *Sitz der Hauptverwaltung* since the French courts seem to stress the nation in which the management and control of a corporation are centered. Although the holdings are not entirely consistent, the emphasis is apparently on the real *siege social* as distinguished from the formal head office.[217]

3. Specific Tax Policy Issues.

The preceding section briefly deals with some approaches of public and private international law to corporate citizenship or nationality. Before scrutinizing the difficulties involved in determining satisfactory criteria of unlimited corporate tax liability based on the status of an international corporation as a "resident" of one nation, one should ask whether or not a corporation ought properly to be the subject of a tax on its income and capital.

*a. Justification for a Personal Corporate Tax.* Inasmuch as a corporation is an entity legally distinct and separate from the shareholders who organize and own it, the notion of taxing it separately has some logical appeal. However, it can be argued from an economic and social point of view that the corporate entity actually represents a merger of various factors of production into a going concern[219] and

215. Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955); Reese & Kaufmann, *The Law Governing Corporate Affairs, Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 118 (1958).

216. KEGEL, *supra* note 197 at 205-209.

217. Weber v. Societé Générale Anglaise et Francaise, (Tribunal Commercial, Nancy 1907) 34 J. DE DROIT INTERNATIONAL PRIVÉ 765 (1907); BATIFFOL, TRAITE ELÉMENTAIRE DE DROIT INTERNATIONAL PRIVÈ 229-241, 450-451 (1959).

218. Bickel, 6 HANDWOERTERBUCH DER SOZIALWISSENSCHAFTEN, at 41, 44 (1959); PECHMAN, FEDERAL TAX POLICY, 98 (1966).

219. ANDERSON, TAXATION AND THE AMERICAN ECONOMY 328 (1951).

that, since the tax on corporations must finally be paid by some individual, taxing corporate profits means taxing some persons more heavily than others through the corporate fiction.[220] The latter argument may be premature as long as the whole issue of incidence and shifting of the corporate tax remains in an unsettled state, despite the large number of analytical and empirical studies which have been devoted to this subject.[221]

A weighty argument advanced to justify separate taxation of corporations is based on the privilege or benefit theory, according to which the government sanctions and protects the corporation's privilege to do business in exchange for special powers of taxation.[222] This notion is probably connected with the original concession theory under which the corporation is a creature of the state, owing its existence and all its rights, powers and benefits to a grant of the sovereign.[223] In addition to the general privilege of corporate existence the special benefits of perpetual life, easy transfer of ownership, limited liability of owners, capital market opportunities, growth through retention of earnings and possibilities of intercorporate affiliations are often advanced to justify the corporate tax.[224] On the other hand, the benefit and privilege theory is challenged by economists chiefly on the ground that there is no sufficiently valuable advantage provided by the government to that special group of legal entities using the corporate form, since it is open to all on easy terms.[225] However, the arguments that the general availability of the privileges of incorporation removes their economic value might be based on a confusion of the term "benefit" with exchange value. Since the state does not limit the issuance of corporate charters they may have no exchange value; nevertheless, the benefit of the charter to those who incorporate their business is apparent since that business is done in the corporate form despite the existence of corporate income and capital taxation. Furthermore, it should be irrelevant that the general and special benefits of incorporation are not exactly measurable, since we are dealing here

220. BUCHANAN, THE PUBLIC FINANCES 297 (1960).

221. Ratchford & Han, *The Burden of Corporate Income Tax,* 10 NAT. TAX J. (1957); Slitor, *The Enigma of Corporate Tax Incidence,* 18 PUBLIC FINANCE (1963).

222. EHEBERG *supra* note 189, at 170.

223. GOODE, CORPORATION INCOME TAX (1951).

224. BICKEL, *supra* note 218, at 42.

225. BUCHANAN, *supra* note 220, at 298. KENDRICK, PUBLIC FINANCE, PRINCIPLES AND PROBLEMS 436 (1951).

with the basic problem of the personal tax liability of corporations, not with the question of the appropriate tax base or proper tax rate.[226] These reflections suggest at least that the case for taxation of corporations is not entirely based on a cynical theory of taxation; which rests content with the argument that the corporate tax is fiscally productive and administratively convenient.

Whether or not the tax is justifiable on a privilege and benefit rationale, the personal taxation of corporations seems sensible, if not necessary, in order to safeguard the policies of the individual income tax because otherwise individuals could avoid being taxed by accumulating income in corporations.[227]

*b. Propriety of a World-wide Corporate Jurisdiction.* Assuming that corporations should be subject to personal tax liability, should countries adopt the rule of world-wide taxation of corporations having a certain connection with the country which applies such a global tax system?

One could argue that a source jurisdiction approach, taxing only income arising from sources within the territory of the taxing sovereign, would be a more realistic policy for taxing corporations, because a corporation cannot have the same status as an individual citizen or resident.

This position is open to several objections. First of all, complete formal equality is not required between corporate and non-corporate taxpaying units in order to apply the same jurisdictional rule. The decisive fact is that both the legal person and the individual engage in similar ways in economic and social activities. Since the corporation is the most significant form of business organization in the modern economy, it is no longer true that this person exists "only in the contemplation of the law."[228] Moreover, the previously discussed treatment of corporations in important extra-fiscal areas indicates that the approach to corporations and individuals is analogous. Finally, the extension of the global jurisdictional pattern to corporations seems to be

226. Logically distinct, although often associated with the privilege and benefit theory, is the cost justification of a separate taxation of corporations. According to the cost theory the taxes levied on corporations shall cover pro rata shares of the social costs incurred by the government in facilitating and promoting private business activities, *see* EHEBERG, *supra* note 189, at 169. However, this reasoning is not conclusive because the acceptance of the underlying idea leads to the propriety of a general tax on business, but not to that of a special corporation tax; KENDRICK, *supra* note 229, at 436.

227. PECHMAN, *supra* note 218, at 99.

228. ANDERSON, *supra* note 219, at 328.

justified not only in the interest of neutral tax treatment of domestic and foreign investment, but also because the country of residence is often the origin of the financial, managerial and organizational factors, including the know-how, which contribute to the production of the global income of the corporation.

*C. Corporate Residence: Problems and Alternative Solutions.*

1. Legal-Political Allegiance v. Socioeconomic Connection.

In approaching the question of a satisfactory residence rule for corporations an initial step might be to get away from the idea of mere political allegiance and to get closer to the principle of genuine economic nexus.[229] Such a position would be in line with the development of policy in other areas of law where there has been a change in the orthodox views of "nationality" and "citizenship" of corporations.[230] The considerations supporting this shift in non-fiscal international law reflect *mutatis mutandis* aspects of special significance in international taxation. In the former emphasis was placed on the real factors of corporate life and thus on the socioeconomic substance within the corporate form. This is more important yet in the area of tax jurisdiction. Because taxation is the process by which a nation transfers economic resources from the private to the public sector, economic realities should be considered first when one defines the proper connection between state and corporation. The contribution to a government's expenses should be imposed upon persons who are more than formally tied to its national economy and public finance. Therefore, it seems rational and logical to grant the personal jurisdiction to tax a corporation to that state from which the corporation derives its real economic vitality, not just its legal existence.

This train of thought, however, encounters possible objections. It rests on the following presuppositions: first, a corporation with multinational activities and affiliations "is" in one nation; second, this "real" center of existence is unequivocally identifiable when one considers every aspect of a corporation's life; third, an objective and absolute standard for determining the decisive corporate incidents can be found; and fourth, the rule of economic allegiance is in principle superior to

229. This view has been expressed, so far as individual taxpayers are concerned, by Bruins, Einaudi, Seligman and Sir Josiah Stamp; *see* 4 JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, LEGISLATIVE HISTORY OF UNITED STATES TAX CONVENTIONS, 87th Cong., 1st Sess., at 4023 [hereinafter cited as LEGISLATIVE HISTORY].

230. *See* pp. 220-222 *supra*.

the legal-political approach because the latter would be inconsistent with the overall tax policy objectives of a given country. All these assumptions carry their peculiar weaknesses. The possible multiplicity of the concrete factors which form the multinational presence of a corporation, (such as the location of shareholders, directors, managers, officers, shops, creditors, holders of debt obligations, and owners of patents and trade marks), renders the formulation of any abstract and absolute standard of corporate residence uncertain. Since personal jurisdictional rules do not exist in a vacuum and are no end in themselves, the policy planner has to take into consideration a country's general tax policy goals when he attempts to develop adequate principles for distinguishing between domestic (taxed on world-wide income) and foreign corporations (taxed on domestic source income only).

2. Criticism of the Unilateral German and American Rules.

Assuming that a good corporate residence rule should be at once unobjectionable under international and domestic law, just and equitable, clear and unambiguous, and fiscally productive and administratively feasible, that it should minimize international double taxation as well as tax evasion, the German and American rules of law[231] might be evaluated as follows.

*Seat* and *place of incorporation* are two residence criteria which, for taxpayer, tax administration and tax judiciary certainly have the advantage of simplicity and predictability.

On the other hand, because these concepts have historical roots in the laws of both countries, they may be regarded as not quite up to date with with respect to general legal-economic thinking and with the development of modern taxation. It seems questionable whether so much weight should be placed rather mechanically and formally, and with such far-reaching tax consequences, on the mere act of legal creation by that state which, in the course of events, may grow to be the country of minimum corporate contacts. The seat and place of

231. The following corporate residence formulas are used by other developed countries:
"Seat": Italy, Japan, Sweden and Switzerland;
"Place of central management and control": France ("siege social") and the United Kingdom;
"Place of incorporation or place of effective management": Canada.
"Statutory office or place of effective management or principal business establishment": Belgium; see KRAUSE & KENNETH, FEDERAL TAX TREATMENT OF FOREIGN INCOME 115-117 (1964).

incorporation test is likely to be based on the now obsolete concession theory, according to which the corporation owes all its rights, powers and benefits to the state which created it.

Such formal jurisdictional approaches may have a tendency to multiply potential conflicts of double taxation quite similar to those which arise if a state asserts global tax jurisdiction on its citizens. Because both are based on the theory of legal-political allegiance, one may assume citizenship of individuals may be compared with seat or incorporation nexus of corporations. In the absence of express relief provisions double taxation due to such rather formalistically devised corporate residence standards is likely since the country where the business activities take place also tends to tax the same income of the same juridical person. While the United States' as well as Germany's tax law contains unilateral and bilateral anti-double taxation devices which counterbalance the undesirable consequences of the seat and incorporation principles, these benefits for the international business world are established at the expense of the desirable simplicity and clarity of the law.

Furthermore, if legally required connective factors such as seat or place of incorporation can be easily met then they permit and encourage a corporation to place economically and financially important operations outside a state's jurisdiction by means of foreign incorporation regardless of domestic ownership, management, know-how and other essential "home" country connections. Tax planning measures in line with such rules which invite tax avoidance focus attention on resulting adverse effects on horizontal equity, on revenue production and on balance of payments policy. This in turn can lead to counter-legislation which further complicates the law. On the other hand one could argue that deferring the tax liability of the domestic shareholders (i.e., postponing taxation of the foreign income until it is realized by the distribution of dividends,) is acceptable as long as a country has no monetary or fiscal problems of capital and money repatriation, and as long as the use of foreign corporations is justified by good business reasons. Such a view could be supported further by arguments of the desirability of tax neutrality for competition in the foreign market, of promotion of the national economy through foreign investment and of administrative convenience. Whether arguments for or against the seat or the incorporation test should prevail cannot be judged by any abstract formula, but depends on the overall state of legal, fiscal, foreign, economic, monetary and administrative policy of the country involved.

As pointed out earlier, the criterion of place of management as an additional alternative criterion of corporate residence was adopted at a time when the German legislature moved away from the citizenship test towards a concept of economic-territorial allegiance (represented by the idea of residence so far as taxation of the individual is concerned). It might be supposed that the place of management standard reflects this approach to a more realistic view of international tax relations on the level of corporate taxation.

The existence of considerable litigation on the interpretation of the statutory definition of the "center of top managment" shows how ambiguous such a concept may turn out to be in practice. Both tax administrators and tax advisers suffer difficulties when they apply a sophisticated residence standard which requires one to take into account all facets of frequently very complex factual-economic situations. On the other hand, the gradually declining amount of litigation in this area may support arguments that every non-formal and economic life oriented approach needs for its development an adequate transition stage after which the judicially clarified rule can serve the underlying policy purposes without more cost in terms of simplicity and predictability than the use of purely legalistic residence determinations.

Obviously, the adoption of the place of management alternative broadened the German revenue basis. This enlargement of the jurisdictional is hardly objectionable from the viewpoint of tax justice and equity. It seems proper to accord the privilege of world-wide taxation to that country from which the direction and control of the world-wide business activities of a corporation are conducted. It appears defensible to look at this country as the place where, in a sense, the head of the socio-economic body of the multinational organization is located.

Whereas the place of management standard permits the exertion of tax jurisdiction over a corporation even though organized under foreign law and thus might be expected to counteract undesirable operations or manipulations, this test, in practice, has proven to be an inefficient method of solving all problems of tax "expatriation." The enactment of the residence fiction provisions and the more recent difficulties in handling the problems of tax haven operations indicate this.

Another consequence of Germany's double standard of corporate residence is the increase of potential cases of international double taxation. This is a logical consequence of substantial enlargement — by means of simultaneous adoption of two independent and far-reaching connective criteria — of the personal extra-territorial scope of direct taxation.

Generally speaking, the place of management test is not in itself necessarily more realistic or more satisfactory than the incorporation or the seat standard. Rather, the quality of the approach must be judged by a coutry's tax policy priorities and then by the actual definition of "management." Not only may the interpretation of an established statutory concept of place of management raise intricate questions in the orderly planning and just taxation of international business activities, but also the policy selection of the decisive factors may present its own difficulties. The term "management" is ambiguous and open to different interpretation. Aside from the German concept of place of management, a country may use as criteria for defining management the principal office (Turkey), the place of the meeting of the board of directors (Great Britain) or even the territorial source of a corporation's prevailing income (Pakistan). Where the business activities are carried on or where the central physical facilities are located could also be important. Therefore, in weighing the values and shortcomings of the seat and incorporation tests against the attributes of the place of management standard, one must accurately determine the meaning of the concept of management in question.

The statutory fictional residence rule for certain foreign corporations as enacted in 1934 (§ 15 II StAnpG) is certainly based on a "realistic" consideration of the relationship between domestic enterprises dominating their foreign subsidiaries in every essential respect. One could even argue that it is in a sense improper to call this rule a fiction at all, because it reflects economic realities.

Judged by the standard of genuine economic connection as a jurisdictional policy test in international tax matters, the extension of the original seat and place of management pattern through the "as if" place of management concept seems justifiable. This rule attributes to the foreign corporation the personal status of unlimited tax liability only if the foreign corporation is in economic effect merely an operating division of the resident enterprise, i.e., if the foreign corporation is financially, organizationally and economically integrated into the domestic enterprise. The underlying policy reason might be that the country that exports the business capital and the organizational know-how, which dominates the entire economic life of the subsidiary, should have global tax jurisdiction notwithstanding the lack of formal nexus in terms of seat and place of management. Such a notion would appeal to tax policy planners who advocate the priority of the stronger over the weaker economic contact as the jurisdictionally decisive criterion of personal tax liability.

Subjecting foreign subsidiaries to world-wide domestic taxation is, however, open to question from the international legal viewpoint. Although, after close examination of the issues involved, the German Supreme Finance Court upheld the validity of the statute, rejecting the alleged violation of general principles of the law of nations, such litigation in itself might be unfavorable to international comity.

The extension of the original jurisdictional basis may also be objectionable as a violation of the domestic principle of corporate independence. Even if one admits that this principle is not sacrosanct, it is important to keep in mind that the German law generally allows piercing of the corporate veil *(Durchgriff)* only in the most exceptional cases. The typical exception, abuse of legal forms, normally does not apply to integrated foreign corporations.

Other undesirable aspects of the fictional residence rule are its effects on foreign investment policy, tax neutrality and administrative feasibility. Such a rule hardly seems supportable in the framework of a general economic and foreign policy directed towards promotion of German investment activities abroad. Moreover, the application of the rule creates competitive handicaps for German subsidiaries in foreign markets, if the competitors are free from a similar tax. Furthermore, the administration of this rule causes specific difficulties for the preparation and execution of the annual assessments, all the more so since the domestic dominating enterprise is not responsible for the tax liabilities of the foreign corporation.

Finally, the use of the problematic residence fiction rule as an instrument for fighting "tax haven" operations does not seem defensible. "Incorporated pocketbooks" are out of the reach of the provision since the foreign corporation has to be integrated into a domestic enterprise, and base companies may only in particular cases be covered by this rule which was not devised to handle these modern problems.

The United States "indirect residence rules" reflected in the statutory provisions concerning foreign personal holding companies and controlled foreign corporations, raise a number of policy questions. The proposition of equal treatment of all taxpayers with the same ability to pay supports any attempt to minimize tax avoidance and unjustifiable loopholes. To that extent it seems sound to utilize the domestic residence of the shareholders of closely held foreign corporations as a connective factor for reaching the income of such tax avoiding corporations. To this aspect of equalizing the tax burden on domestic and foreign income is added the fact that the indirect resident rules tend to equalize tax incentives for domestic and nondomestic investments.

Furthermore, the "indirect" corporate residence approach based on a "residence of shareholder" test might be an efficient technique to secure revenues since it makes it difficult to put income earned abroad outside the reach of the domestic tax or to influence the timing and amount of tax liability. Moreover, determining in effect the residence of the foreign corporation involved according to the residence of its domestic shareholders, and requiring the resident shareholders to include in their taxable income their pro rata share of the corporation's undistributed profits — income considered to be earned through tax avoidance transactions and organizations — might actually discourage investment abroad, induce repatriation of capital and dividends and consequently help to mitigate the government's balance of payments problems.

Disregarding the principle of separation of corporation and shareholder in order to make more efficient the assertion of tax jurisdiction does not seem objectionable when considered against the background of a not overly rigid national tax law which, for example, offers to its corporate taxpayers the preferential treatment of partnerships ("Subchapter S corporations") or an indirect foreign tax credit for corporate taxes on foreign subsidiaries.

The highly controversial and basic question of the appropriateness of the tax law as a means to extra-fiscal ends arises with indirect residence rules based on considerations of balance of payments policy. The attitude of modern governments that taxation can be used not only for revenue purposes but also as an instrument of general internal and foreign policy is supported by the view that income tax issues, especially, ultimately involve questions of basic social and economic policy. On the other hand, one could argue that all governmental action should be direct, visible and controllable and that the use of taxation for major extra-fiscal purposes leads to growing tax law complexities, hidden inequities, as well as administrative and judicial difficulties. In the case before us, however, it should be noted that the United States government cannot easily achieve its international monetary objectives through technical monetary measures. Any direct control of the international capital movement by means of currency regulations might have a negative impact on the dollar as world currency.

The use of residence of shareholder test as a definition for indirect global jurisdiction over "foreign" corporations may be questionable inasmuch as this approach implies possible conflicts of legal interests and unsatisfactory administrative consequences. It is conceivable that there are cases in which the United States shareholder is legally required to give information on facts which under the commercial law of the country of incorporation may not be disclosed to the shareholders or other persons.

Finally, it is possible that there are constitutional objections to the "indirect" corporate residence approach. Whether or not the taxation of undistributed corporate profits to the controlling United States shareholders is covered by the constitutional provisions for income taxation, due process and commerce with foreign nations raises complex questions which cast a slight shadow on the constitutionality of the foreign personal holding company and controlled foreign corporation provisions.

3. Model Bilateral Concepts of Corporate Tax Residence.

A brief review of pertinent drafts proposed by leading international organizations may provide some comparative standards for the evaluation of existing bilateral corporate residence rules established through the American and German international tax conventions.

*a. League of Nations: Report and Resolutions 1925.* Official technical experts who were nominated by various governments submitted a report and resolutions on double taxation and tax evasion to the Financial Committee of the League of Nations.[232] They suggested some modifications of the extra-territorial unilateral rules and international conventions of various nations.

232. 4 Legislative History, *supra* note 229, at 4057, 4095.

As far as corporate tax residence was concerned it was recommended that the state of residence ought be the state in which the "head office" is situated or, if that office is not the "real center of management and control" of the undertaking, the state in which this center is situated.[233] According to the official comment to the resolution the tax residence ("fiscal domicile") of corporate bodies should be the place where the concern has its "effective center," i.e., the place where the "brain," the "managment and control" of the business is situated.[234]

*b. League of Nations: Draft Plurilateral Conventions 1931.* In 1931 a special sub-committee, appointed by the Fiscal Committee to draw up a draft plurilateral convention based on certain principles deemed acceptable for a large number of countries, submitted three alternative draft conventions for the prevention of the double taxation of certain categories of income.[235] So far as the concept of corporate tax residence is concerned the pertinent articles in all three alternative drafts define, although through different wording, the fiscal domicile of a juristic person as its "real center of management."[236]

*c. League of Nations: Model Bilateral Conventions 1946.* The Fiscal Committee of the League of Nations suggested in 1939 a revision of the draft bilateral conventions of 1928 in view of various improvements contained in a number of subsequent international tax treaties. In addition, new trends and problems had appeared in the fields of international trade and investment. The new draft treaties were to take into account the technical progress and the changed views since 1928.

The work of revision and codification was undertaken by a subcommittee which held several meetings in Mexico City and London. The membership attending the meetings varied. Because the participants of the meetings held different views on various points, the Fiscal

233. *Id.*, at 4095.
234. *Id.*, at 4081.
235. League of Nations Doc. C/1/15/M/171/IIA (1931) in LEGISLATIVE HISTORY, *supra* note 229, at 4234, 4237, 4239. A REPORT ON DOUBLE TAXATION AND TAX EVASION, presented in 1928 by the general meeting of government experts, contains different bilateral model conventions which are based on the technical experts' draft of 1927. None of these explicitly defines the corporation's tax residence. However, some provisions seem to suggest implicitly the "real center of management" as the underlying idea, *see* League of Nations Doc. 216/M/85/II (1927) in LEGISLATIVE HISTORY, *supra* note 229, at 1121, 4125, and League of Nations Doc. C/562/M/178/II (1928) in LEGISLATIVE HISTORY, *supra* note 229, at 4162, 4170, 4173, 4174.
236. LEAGUE OF NATIONS DOC. C/1/15/M/171/IIA, *supra* note 235, art. I.

Committee published both model conventions in its report of 1946 and expressed the hope that the League's work on international tax problems would be reviewed and developed by the United Nations.[237]

Article II(4) of the Protocol to Mexico Draft states that the tax residence ("fiscal domicile") of companies and other legal entities shall be the country under the laws of which they were constituted.[238] According to the commentary this place of organization concept was favored on the ground that it more closely agreed with American legal systems.[239]

According to Article II(4) of the Protocol to the London Model Convention on the prevention of double taxation of income and property the tax residence of corporations is the state in which the corporation's "real center of management" is located.[240] The official commentary states with respect to the London formula of corporate residence that this definition rests on the earlier work of the Fiscal Committee and that most intra-European tax conventions use this residence test.[241]

*d. O.E.E.C.: Report 1958.* The Fiscal Committee of the Organization for European Economic Co-operation (O.E.E.C.) in 1958 reported to the council its findings on some questions relating to double taxation.[242] The underlying studies were directed to the establishment of a uniform line of conventional practice acceptable to all the member countries. Representatives of the United States had participated in the meetings and discussions of the Committee. One of the Committee's tasks was to draft a proper bilateral concept of fiscal domicile. Article III of the Annex to the Report[243] gives the following definition of residence: the term "resident" of a contracting state means any person who, under the law of that state, is liable to taxation therein by reason of his domicile, residence, place of management or any similar criterion. The possible problem of double corporate residence is

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237. LEAGUE OF NATIONS DOC. C/37/M/37/IIA (1946) in LEGISLATIVE HISTORY, *supra* note 229, at 4299-4405.
238. *Id.* at 4392.
239. *Id.* at 4331.
240. *Id.* at 4393.
241. *Id.* at 4331.
242. *The Elimination of Double Taxation* in LEGISLATIVE HISTORY, *supra* note 229, at 4445-4506.
243. *Id.* at 4479.

handled in the following manner: where a legal person is a resident[244] of both contracting states, then it shall be deemed to be a resident of the contracting state in which its "place of effective management" is situated.

The Report contains among other things the following explanatory remarks on Article III:[245] the Article is intended only to solve the conflict between two residences if both contracting states claim residence of the person concerned under their respective municipal laws. The conventions do not establish standards for the national rules on residence. Rather, they provide only a special provision for particular treaty cases where the conflict between two residences cannot be solved by reference to the unilateral concepts. On the one hand the proposed preference criterion "place of effective management" was based on the idea that it would not be natural to attach importance to a purely formal test. On the other hand, a study of existing treaties concerned with income of shipping and air transport enterprises led to the formulation of the preference standard. These conventions frequently assign the power to tax to that state in which the "place of management" or the "place of effective management" or the "business management and control" is located.

*e. O.E.C.D.: Draft Double Taxation Convention 1963.* The Organization for Economic Co-operation and Development (O.E.C.D.) was set up in 1960 under a convention[246] signed by the member countries of the O.E.E.C.[247] and by Canada and the United States. The legal personality of the O.E.E.C. continues in the

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244. The Report, for terminological reasons, thought it appropriate to use the term "resident" as a shorthand expression in all cases where the state of "domicile" is mentioned. The term resident is used in American and British international conventions and on the French part the expression *"un resident"* is found. *Id.* at 4500.

245. *Id.* at 4499-4502.

246. The Convention provides that the O.E.C.D. shall promote policies designed:
- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries while maintaining financial stability, and thus to contribute to the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development;
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations. *See,* O.E.C.D. FISCAL COMM. REP. DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL, at 4 (1963) [hereinafter O.E.C.D. DRAFT].

247. The O.E.E.C. included the following countries: Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the United Kingdom.

O.E.C.D. and the mandate of the O.E.E.C. Fiscal Committee was confirmed under the O.E.C.D.

In 1963, the Fiscal Committee submitted a draft double taxation convention on income and capital to the Council[248] (hereinafter O.E.C.D. draft) which is composed chiefly of articles already drafted under the O.E.E.C. with relatively few new provisions.

That part of Article 4 of the O.E.C.D. draft which deals with the question of corporate residence is in essence identical with the O.E.E.C. draft already discussed. The reasons given for the proposal[249] are also identical. Thus, the O.E.C.D. draft establishes no specific treaty residence rule but refers to the respective national standards of corporate residence. In case of possible conflict of double residence, the place of effective management shall be the preference criterion. There is no treaty definition of what constitutes effective management. Since the United States has traditionally used the place of incorporation as the jurisdictional basis, it has reserved its right to do so when entering into tax treaties with other member countries of the O.E.C.D.[250]

4. Criticism of the Bilateral German and American Approaches.

Under the present state of German tax treaty law, it is questionable whether or not existing corporate residence tests as yet satisfactorily serve the immediate treaty purpose of double taxation avoidance and the ultimate objective of promoting international exchange of goods and services as well as movements of capital and industrial operations.

One specific weakness of the bilateral rules is the still considerable dissimilarities of the controlling standards. The lack of uniformity in solving identical residence questions creates an area of uncertainty which should be removed in the interest of tax law and taxpayers. Twelve German treaties which have adopted original bilateral tests use not less than four different concepts of corporate residence. This undesirable situation is accentuated by the sweeping absence of conventional definitions of the controlling criteria. Only two treaties provide for a bilateral determination for defining the place of management as the center of top management. However, such a short formula,

248. O.E.C.D. DRAFT, *supra* note 246.
249. *See* Commentary on Article 4, O.E.C.D. DRAFT *supra* note 246, at 66.
250. *See* special comments on Article 4, O.E.C.D. DRAFT, *supra* note 248 at 67.

which the German unilateral concept of corporate residence presumably sponsored, supplies little guidance in terms of predictability. A less abstract definition probably would be better suited to the treaty purpose.

Judged by standards of uniformity and predictability, the United States body of tax treaties is less objectionable. This is mainly due to the fact that all United States treaties adopt for American corporations the clear and simple place of incorporation test as established by the Internal Revenue Code.

Assuming that tax treaties should not leave open the basic question of residence, German conventions are quite adequate. With only two exceptions, all treaties under which the conflict of double residence may arise provide a preference criterion for corporate residence. The striking lack of preference rules in United States treaties as well as of treaty definitions in cases of non-congruent residence concepts appears quite different from the German point of view when one considers the prevailing American treaty philosophy. Since in principle the United States reserves the right to tax its citizens, residents and corporations regardless of any other treaty provision, it is clear that conventional imperfections or even basic defects which make treaties inapplicable are of minor importance.

At this point, the specific obstacles to the adoption of bilateral draft conventions become evident. Even the O.E.C.D. draft which, unlike its predecessors created under the auspices of the League of Nations, does not propose an original bilateral residence concept and provides only for the solution of the conflict of double residence, appears not to be acceptable for every member country. Whether the United States' reservation to the O.E.C.D. draft's preference criterion rests on the well established tradition of its jurisdictional system or on the O.E.C.D.'s unconvincing arguments in favor of the concept of effective management is uncertain. While such a concept fits well in a jurisdictional pattern such as the one which Germany used from the beginning as its extra-territorial corporate taxation policy, there is no reason for its adoption by tax systems founded on entirely different notions of a corporation's personal tax status. In view of the complexities inherent in the place of management concept, the lack of an overall rationale for the draft's preference criterion, and the United States' extensive historical commitment to its own unilateral residence rules and relief provisions, the United States' reservation is understandable.

*Concluding Remarks*

The variety of the rules in effect and the difference in the underlying philosophical and traditional notions render it difficult to find a definite answer on the multiple problems of desirable uniformity of formulation and application of adequate residence standards for internationally operated corporations. A healthy skepticism of any "ideal," "absolute" and "universal" solution of this basic tax policy issue seems to be appropriate. The conditions vary from country to country, the problems presented change from time to time and questions of international tax jurisdiction involve significant aspects of legal, fiscal, economic, administrative, social, moral and foreign policy. The policy planner must not only be skilled in the technical questions, but should also be aware of the political, economic and social forces which confine the law making process.

## Appendix A

### *Decision I A 452/30*[251]

Appellant corporation having its seat in X (Switzerland) was taxed on its total income. The Revenue Service took the position that the place of management was in Germany, namely in H.

Appeals below were unsuccessful. The present appeal succeeds.

The Tax Court based its solution on the theory that the place of management is the place of actual executive management, which in turn is the office where the essential transactions are entered into. Such transactions include purchasing of raw materials, their processing, keeping of the inventory, sales and shipment.

We find this is a misunderstanding of the place of management concept: The Tax Court does not distinguish between the numerous though important business activities and the management. Having an office for purchase in Japan, a factory in Germany, the inventory and shipping division in Holland, the sales in the United States, does not necessarily mean that the place of management is located in any of these countries. Evers' commentary is right in pointing out that while the seat is a legal question the place of management is a factual one, very different from case to case and difficult to supervise by the Revenue Service in view of the fact that organizations and activities abroad come into question. There is no simple earmark such as location of books or funds which is decisive. At any rate, by locating the place of management at the situs of several business events instead of the top management the Tax Court has misconstrued the concept of place of management and its solution cannot stand. Further fact findings will have to be made.

The findings of the Tax Court are based mainly on affidavits by the general representative S in H (Germany) and on facts surrounding the founding of the corporation. At the same time there were statements made by the appellant corporation's general manager A whose domicile is in X (Switzerland) which is the appellant's seat.

The general picture resulting from the record shows the founding of appellant in 1920, its incorporation in Switzerland with a capital stock of 600,000 sfr. From its capital, 100,000 sfr were subscribed to by Paul Sp. of Germany, one of the owners of K & S, a German company. This German company discontinued, on January 1921, the production of textiles at its own risks for sales on the market and manufactured after that date woven materials exclusively for appellant corporation who supplied the raw textile. Simultaneously, the sales manager, S, withdrew from the German company and become general representative of the appellant. His affidavit shows the following facts: The company's owner Sp. suggested his employment by appellant which took over at the same time the former sub-agents from the company. S's activities were concentrated upon Germany and some foreign countries (Sweden, Norway, Denmark, Holland). He had no connection with sales to England, Belgium, France, Canada, Austria, etc., the agents (= representatives) in those countries were under the direct supervision of the appellant's general manager A. They sent only copies of the contracts with clients to S in order to enable him to place the order with the German company for production and shipment. He worked out the details of such production orders under the guidance of appellant. The appellant's manager was in this respect his superior, although as a general custom the Swiss manager agreed with his propositions and allowed him sufficient independence. The orders collected by sub-agents had to be forwarded by S to the appellant and only by its approval could a contract be entered into. S had nothing to do with accounting which was performed by appellant

251. RFH June 16, 1931, 29 E 78.

in Switzerland, where also all payments and letters of clients were handled. Warranties were generally disposed of by S or the sub-agents. Besides S two other former employees of the German company had joined appellant. The office was located on a rental basis in the building of the German company in the proximity of the factory. S and his employees were not subordinate to the German company, but there was collaboration to correlate production and sales. S had permanent access to the warehouse of the German company which was kept for appellant. When there were temporarily no orders to be fulfilled on behalf of appellant, general representative S was consulted by the German company on what to produce to prepare for future orders. However, if sizable items were in question, appellant in Switzerland had to be consulted, representative S having no power to decide.

From all the above facts, the general impression one gets is that S, while having some freedom of decision, under no circumstances can be regarded as doing the job of a manager of appellant. He was limited in his competency, the greatest part of foreign sales being conducted directly by manager A in Switzerland.

Furthermore, the leadership for the purchases of raw materials was exercised by appellant in X. As Germany was in those years the leading producer of synthetic fibres, these purchases were understandably handled by the German company. But this was not true for the natural silk. According to the records more than two thirds of all purchases were done directly by appellant.

The production took place exclusively in Germany. The record does not contain data concerning controls by appellant as to the production. However, it is in the nature of the arrangements here presented that contracts entered into or approved by the appellant in Switzerland were determinative of what ought to be produced in Germany.

Appellant's main deposit of merchandise was located in proximity of the German company's factory. There were additional deposits in Berlin, London, Glasgow and Manchester. Since there was no deposit in X (Switzerland), no shipping activity took place from there.

Putting together all findings on procuring raw materials, production, warehouses, sales, shipping, accounting and funds, the assertion by appellant, that its management (i.e., the center of top management) is in Switzerland, has not been disproved. Consequently, there is no basis for an unlimited personal tax liability of appellant. On the other hand, a limited tax liability results from appellant's permanent establishment and permanent representative in Germany.

## *Decision I A 344/32*[252]

Appellant corporation has its seat in the Netherlands. Seventy-eight percent of its common stock has been owned since its organization by P in Germany, sole shareholder and manager of a German lumber company with an activity very similar to that of the Dutch corporation.

In issue is the unlimited corporate tax liability of appellant. The Revenue Service determined that the corporation's place of management is in Germany. Appellant's petitions below were unsuccessful.

The Tax Court based its decision on the principle that, in case of doubt, the permanent commercial domicile of the corporation's sole owner or chief shareholder will constitute the place of management of the corporation, especially if the most important business events occur at that place. The Tax Court relied on the influence a sole owner or principal shareholder generally has upon the affairs of the corporation, often amounting to real managing of the corporation, with the effect that the formal managers are in fact only instruments of such shareholder's wishes and have only the appearance of being managers of corporate

252. RFH January 9, 1934, 35 E 133.

affairs. The court relied on the more than 75 percent ownership by P, on similar commercial activity of P's German company, on the corporation's activities in Germany such as selling of lumber products and buying timber through P, utilizing P's German company to transform it into lumber, and finally on the fact that P was previously active as a manager of the Dutch corporation and quit this job in 1930 when the unlimited tax liability of appellant was sought by the Revenue Service.

Appellant advanced the argument that in spite of his over 70 percent ownership of the common stock, he never had a controlling influence on business affairs of the corporation. Appellant and P's German company were completely independent, neither could impose its will upon the other. The fact that P was called a director of appellant was irrelevant as to influence on corporate affairs, as long as it was a Dutch custom to give such title to any substantial shareholder — a gesture amounting to mere formality — while the real authority was vested in one principal director, obviously not P who was without the requisite knowledge of the Dutch language and unfamiliar with the Dutch legal system.

Appellant should succeed in its appeal.

As appellant has its seat abroad, the decision of the case depends upon the location of its place of management. According to our holding in I A 462/30 (E 29 p. 78) the place of management is where the center of top management is. The Tax Court has misconstrued this definition when purporting to find the place of management, in doubtful cases, at the commercial domicile of the sole owner or principal shareholder. For the opportunity of such a person to influence because of his financial investment the conduct of a corporation's affairs is not a sufficient basis, without further proof, that he in fact was the manager of the corporation. The place where the various business events took place is equally irrelevant. For there is no need for a corporation to manage its affairs at the scene of its essential dealings. (The only place relevant is that from which the top decisions really emanate.) In this respect the Tax Court has relied on several indicia of management, insufficient, however, to constitute a basis for its finding. The fact that P was active in Germany, that he bought and sold on behalf of appellant, cannot lead to the conclusion that he managed the corporation, for his activities are comparable with the work done by a subordinate of the real top management. The same may be true regarding the title of "director". Even without accepting appellant's theory of directorship constituting a mere formality we are unable to find proof of P's managerial activity. On the contrary, the record contains evidence of the activities of a top manager residing in the Netherlands.

The findings of the Tax Court cannot stand.

## *Decision I A 129/33*[253]

The appellant corporation was founded in 1929 and has its seat in Rotterdam. The founders were Mr. E owner and manager of the German company B, Mr. H an engineer and Dr. D an attorney, all three residing in Germany. The initial capital of the corporation consisted of patent rights valued at 10,000 Dutch florins, for the manufacturing of lifeboats. The reasons for incorporating in Holland, as stated by appellant, were the high tax burden in Germany making impossible the accumulation of capital necessary for an efficient exploitation of patents and the impossibility of dealing with an important part of the world without using this corporation. The statutory representatives (managers) of appellant corporation in 1929 were the co-owners Mr. E and Dr. D.

The Revenue Service found out about the existence of the corporation when auditing the German company B. It then assessed a tax for the year 1929 upon the entire income of the corporation.

The Tax Court declined to review the findings of the Service.

253. RFH July 3, 1934, 36 E 244.

The decision below is correct in holding appellant taxable on total income. While having its seat in Holland, appellant's duty to pay taxes on world-wide income is a result of its place of management being in Germany. Its determination is a question of fact and can be explained in the location of the center of top management. Consequently, it is not important where the directives and declarations given have legal effect; rather the place of importance is where such directives and declarations come from. As a rule, this will be the place where the offices of the top manager or top managers of the corporation are located. In the instant case, however, the persons managing the corporation's business have no office for such purpose. This may be explained by the nature of appellant's business, i.e., patent licences, a type that can be conducted either by contracting with the customers at the residence of the managers or by giving powers of attorney to somebody outside the state. However, when giving a power of attorney to somebody abroad as in the present case, the very act of giving this power takes place in Germany and constitutes the managerial act that counts in finding the place of management. As the residence of both managers was in Germany, the corporation's place of management was in Germany in the case at bar, and consequently the German taxation on world-wide income was legal.

## *Decision III A 98/35*[254]

The issue is whether appellant is subject to unlimited capital tax liability since 1928 because its place of management is in Germany.

The Tax Court has answered this question in the affirmative on the following fact findings: Appellant has its seat abroad. Ninety percent of its capital is owned by Mr. A in Germany who is at the same time principal shareholder of the X shipping corporation and chairman of the board of directors of appellant. Both appellant and the X corporation deal in maritime transport. The business policies, the financial transactions and all other important questions on business activities of appellant are determined in X where, moreover, its annual balance sheets are made, the net profits of which accrue to the X corporation. During an audit concerning X the statement was made by Mr. A that his influence upon appellant was big enough to make any important activity impossible without his consent. In view of these facts the Tax Court found that appellant, like other foreign investments of X, was economically only a department of Mr. A's shipping combine, that its factual existence, notwithstanding its legal independence, rests exclusively on this combine, and that appellant must be considered as part of one integrated business residing in Germany. Appellant's formal manager was to be deemed a subordinate employee of this combine so that the place of management was located in Germany.

Appellant's arguments cannot disturb the Tax Court's findings.

There is proof in the record that all important decisions of appellant are taken by Mr. A. The lower court's holding, based on Mr. A's own statement, is uncontradicted. From this fact the lower court could find that the affairs of appellant were conducted from Germany and base its findings of the place of management in Germany. The other reasonings of the Tax Court, namely the interdependence of the corporations involved are of no legal significance. It is also irrelevant that appellant was founded under foreign law and that it acts legally independently. The place of management is where, as a matter of fact, all of the top managerial decisions are taken that are necessary for the conduct of appellant's business activities. In the case at bar, the top manager was Mr. A in Germany. Consequently, appellant is subject to unlimited capital tax liability under German law.

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254. RFH July 25, 1935, 1935 RStBl 1366.

## *Decision II A 107/35*[255]

The tax liability of appellant, a subsidiary having its seat in Switzerland, depends upon whether its place of management is in Germany, that being the seat and place of management of the parent corporation.

The Tax Court is correct on the initial point that the place of management is at the center of top management. This determination has been judicially developed and is now incorporated in § 15 I StAnpG. This statutory definition is controlling for all kinds of federal taxes. It is irrelevant that the statutory regulation of the term "place of management" was subsequent to the accrual of appellant's tax because the statute expresses only existing law as decisionally determined by the Supreme Finance Court.

The holding of the Tax Court and its findings cannot be disputed. We too are of the opinion that the place of management of appellant was in Germany.

The former president of the German parent was the founder of appellant, and he determined permanently the subsidiary's activities. The control resulting from the legal and factual relations between the two corporations was insured through agreement with a Swiss bank, whereby the bank made certain that the subsidiary's managers adhered to the instructions of the parent concerning the conduct of the subsidiary's affairs. Granted that the Swiss managers had some independence to manage and transact some of appellant's business, it does not count for the determination of the case before us. For not management, but the center of top management, is the crucial point in the issue where the "place of management" is located. The top management, however, was exercised by the president of the parent in Germany. To effectuate the management of a subsidiary, a permanent office in Germany for this purpose is not indispensable. Consequently, it is irrelevant whether or not such an office has been in Germany.

The fact that the parent corporation's president was directing appellant's affairs not constantly from Germany, but also when traveling from other places in Germany and abroad, is equally unimportant because it is the center of top management, and not occasional instances of managerial activity that count. The center of top management, however, was here at the seat of the parent corporation.

Our opinion in the present case is in harmony with former cases. This court stated in the decision of January 12, 1933, (E 32 p 249): The place of management of an integrated corporation is not where the dominant corporation is managed but where the statutory managers of the integrated corporation carry out their activities. The same court expressed in the decision of July 25, 1935, (RStBl 1935 p. 1366) the following opinion: The place of management of a corporation with seat abroad is in Germany if this corporation is under control of a domestic individual to such an extent that the individual determines all important managerial measures of the corporation. Similarly, when control is exercised through a domestic corporation, the place of management is the domestic corporation's residence. It does not follow that all foreign subsidiaries have their place of management at the parent's place of management. Only if the German control is of such a high degree as it was the case in the decision of 1935, do we find that the place of management of the foreign incorporated subsidiary shifts to Germany.

Affirmed.

## *Decision I A 150/36*[256]

Appellant was founded in 1923 and incorporated in Danzig. Its capital consists of all properties of Mr. A who is the sole shareholder and the chairman of the supervisory board.

255. RFH June 19, 1936, [1936] RStBl 765.
256. RFH July 3, 1936, [1936] RStBl 804.

The Revenue Service found that appellant was managed from Germany and consequently has taxed it on its world-wide income. Appeal to the Tax Court was unsuccessful, except for the years for which taxation was held to be barred because of statute of limitation.

Appellant cannot succeed in its appeal before us.

According to the corporate income tax law corporations are subject to unlimited tax liability if the seat or the place of management is in Germany. Appellant's seat is in Danzig, a foreign seat for purposes of tax law. Hence, the only possible basis for appellant's unlimited liability may be its domestic place of management. As we ruled in E 29 p. 78, place of management means the center of top management. This is now the statutory definition (§ 15 I StAnpG). The determination is essentially a question of fact and not of law. The Tax Court had made a fact finding to the effect that appellant's management is in Germany, in Mr. A's (appellant's sole shareholder) hands.

Appellant is not right in arguing that the Tax Court has misconstrued the Supreme Finance Court's center of top management rule. The Tax Court has clearly based its holding not on the mere fact that the sole shareholder was a resident of Germany, but on the reasoning that the place of the real management is controlling. Appellant wants us to believe that the management of a corporation is done from the place of its legal representatives (Vorstand, Geschäftsführer), that is in Danzig. However, this is not necessarily so. While officers and directors may be abroad, the soul of the corporation, the master-mind, may be in Germany, the last word may be said in Germany, and the so-called management may be in fact mere subordinates of the ruling German top manager.

Appellant is wrong in contending that the Tax Court has misconstrued the concept of place of management when it held that the place of final decision of the corporation's future is relevant, because that place is necessarily at the owner's residence and this would subject to world-wide taxation all foreign corporations owned by Germans, and disregard the Supreme Court's admonition to consider a multitude of facts when determining the place of management. The Tax Court had considered a multitude of factual details when it made its decision.

Appellant further contends that the Tax Court erred in basing its conclusion entirely on a finding that the sales for 1928 were made by the sole shareholder and not by appellant's legal representatives, without any proof for the following years. However, the Tax Court did not base its findings solely on those sales; it mentioned the fact as a very important indicium of management, but it was not the only proof in that direction on which the decision below was based.

The rest of appellant's contentions are directed to the interpretation that should be given to the evidence. It cannot be said, however, that the Tax Court's valuation of the evidence was unreasonable and in conclusion it should not be disturbed.

Affirmed.

## *Decision III 40/38*[257]

The issue is whether or not, appellant corporation should pay capital tax on worldwide basis. The Tax Court found that appellant having its seat abroad was managed in Germany on January 1, 1935.

Appellant admits that it was a controlled corporation, but argues that the controlling corporation was not the Germany corporation B, but the foreign corporation C. Appellant states in support of its argument that C ruled its board of directors, was its chief creditor and owned practically all of appellant's shares.

The relevant facts are the following: The German partnership of brothers B was engaged in manufacture of cigarettes. Purchases of tobacco were made abroad and it was an economic necessity to found a purchasing corporation, namely appellant. The partnership B in turn incorporated in Germany (becoming corpora-

257. RFH June 23, 1938, [1938] RStBl 949.

tion B), its shares and all the shares of respondent belonging at first to the two former partners, and later to their heirs. In order to facilitate financing, corporation C got into the picture. C, being enaged also in other financing transactions, was charged with the "management" of appellant in order to allow a better appraisal of the risks involved in the financial affairs of appellant.

According to § 15 I StAnpG the term "place of management" means center of top management. If such managerial activities coordinate international affiliations, we have to look at the place wherefrom the directives and manifestations of will are given, not at the place where they become effective. In this respect, it is relevant that appellant's purchasing activities, as to quantity and quality, are entirely dependent upon the domestic corporation B's production and sales and that appellant must follow B's instructions given personally by special commercial travellers of B. It cannot be denied that appellant's knowledge of what to purchase is based on the specialized knowledge of B's staff and that appellant has to act according to the resolutions and decisions of B. Corporation C is mainly concerned with the risk aspects of the transactions to safeguard its interests as a moneylender. The entire picture and history relating to appellant's foundation show clearly that the top management was in Germany. It is irrelevant for this opinion that appellant was wholly owned by German shareholders because the will of controlling shareholders is principally not the same as management. Since the above findings are sufficient to assume the real place of management in Germany, a discussion of § 15 II StAnpG dealing with fictitious residence of non-resident integrated corporations would be superfluous.

Affirmed.

## *Decision III 135/39*[258]

Appellant corporation was incorporated under American law, has its seat in the United States and was taxed for the year 1936 on its world-wide capital, because its place of management was in Germany. Appellant contests the finding of facts concerning the place of management and its unlimited tax liability.

According to § 1 I VStG 1934, corporations like appellant are subject to unlimited capital tax liability when either their seat or their place of management is in Germany. Place of management, for purposes of taxation, means the center of top management (§ 15 I StAnpG). This may be, according to our previous rulings, the place where the last word is said in matters of greater importance for the corporation's conduct of affairs (E 39 p. 305) or wherefrom and by whom the managerial orders are conceived (RStBl 1938 p 949). Considering all the relevant facts the answer is not simple. However, the decision below is based on a misconception of the term center of top management. The Tax Court confuses top management with control by virtue of majority stock ownerships. Acts by virtue of this financial and legal power are not necessarily acts of top management. It is absolutely compatible and natural for a majority stockholder to acquire information about the business activities continually and not to rely on annual reports or balance sheets, especially in the case of a foreign incorporated corporation. The majority stockholder should not be relegated to waiting for business information until it is too late. His investment entitles him to be continually informed. Similarly, by virtue of his financial interest he has the right to make suggestions and give advice to the corporation's management in order to minimize costs and to stimulate the highest possible profits. It may be a duty incumbent upon the management to consult a principal or sole stockholder in matters of unusual importance or of an unusual nature. He should be consulted, e.g., concerning problems of very extensive credit, building of new factories, important purchases that may affect cash liquidity, foreign investments, breaking into new markets, etc.

258. RFH July 11, 1940, [1940] RStBl 706.

Consultations on matters of such importance are the byproduct of the principal shareholder's relationship with the corporation and should not be considered as exercise of top management. This is especially true in the case of foreign subsidiaries. It is only the right of continual and actual interference with day-to-day business activities by the majority shareholder that transcends the sphere of shareholder-management consultation and amounts to top management by the shareholder.

The error of the decision below was exaggerated legal significance accorded to the activities of the German 80% shareholder. Such activities as shown by the record were limited to letters and suggestions entirely compatible with his interest as a majority shareholder and had no connection with top management of the corporation's affairs. Consequently, the place of management remains in the United States and cannot be shifted to Germany.

Reversed.

### *Decision III 215/56 U*[259]

The appeal must fail.

The lower court held, relying on the RFH decision of January 12, 1933, that an integrated company's place of management is always where the company's statutory management carry out their duties. Appellant correctly points out, however, that the lower court has failed to recognize that substantial parts of the above decision were modified by subsequent decisions of the Supreme Finance Court, especially by the decision II A 107/35. In line with the last-mentioned case it is our opinion that generally the mere fact of dependency of an intergrated company upon the dominant company does not without additional facts transfer its place of management to the place of management of the dominant company. However, in particular cases under peculiar circumstances such shift may take place. Consequently, an integrated corporation's place of management is sometimes determined by the place where its statutory management is acting.

### *Decision II 106/60*[260]

The issue in the instant case is the center of top management of an integrated company.

There is only the decision III 215/56 U of the Bundesfinanzhof dealing with this problem. In that case, based on the decision II A 107/35 of the Reichsfinanzhof, our brothers decided that generally an integrated company's place of management is where its executives are acting, but that by way of exception this place shifts to the place of management of the dominant corporation. Such exception may be found if the dominant parent, as a matter of fact, determines all important business decisions of the integrated daughter. Therefore, a departure from the general rule is justified, if a legally independent company, because of its factual relationship with the dominant corporation, acts like an operating department of the dominant. Relevant for such a finding is the real course of affairs, not the contractual arrangement between integrated and dominant corporation.

Lacking evidence concerning the factual relationship between the companies, the decision below is based primarily on the interpretation of the agreement between the involved taxpayers. This constitutes a violation of procedural and substantive principles.

Reversed and remanded.

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259. BFH August 9, 1957, [1957] BStBl 341.

260. BFH June 10, 1964, [1964] DStZ/E 501.

## *Decision I 13, 14/65*[261]

We have to decide whether respondent corporation, incorporated under the laws of Czechoslovakia, is subject to unlimited or to limited corporate income tax liability.

Respondent had its seat in Prague and was nationalized in 1945 without compensation. Respondent owns assets in German banks and assets in at least one other European country. A trustee was appointed to take care of the assets within Germany, a separate trustee was appointed abroad to take care of those assets. Both trustees, being independent, were not acting in concert.

The Tax Court denied respondents unlimited tax liability on the theory that having assets in the Federal Republic of Germany handled by an appointed trustee is not tantamount to having a place of management in Germany. Notwithstanding the fact that the nationalization had no extraterritorial effect, leaving, hence, untouched respondent's legal entity for purposes of German tax law, the mere presence of assets in Germany does not amount to domestic place of management because of the simultaneous existence of other assets and another trustee in another country.

The Revenue Service argues that the assets in Germany should be treated as a separate corporate entity, regardless of whether or not there are additional assets in some other country of the free world.

The Tax Court was correct when it held that the nationalization by the Czechoslovakian government was without legal effect as to the existence of the corporation outside Czechoslovakia and that respondent continued to exist as a taxable entity in Germany. Nationalizations operate only within the boundaries of the state taking such measures.

It is true, our brothers determined in the decisions I 57/56 U and III 229/56 U that the management in Germany may be exercised by trustees as to assets belonging to corporations which are nationalized by foreign governments. However, the distinctive feature of those cases was the fact that those nationalized corporations owned assets exclusively in Germany managed by only one trustee.

In the case at bar, it is undisputed that the trustee in Austria managing the Austrian assets is independent and not a subordinate to his German counterpart. This is of ultimate significance for the question whether the activities of the domestic trustee are management in the statutory sense. The continuation of the legal existence of respondent except within the nationalizing state is not restricted to the territory of the Federal Republic but extends at least also into Austria since respondent owns assets in both countries. Consequently, respondent's unlimited liability as one taxable unit depends upon the existence of one place of management for the entire surviving corporate enterprise. The domestic trustee can only be regarded as the top manager of respondent if he controls both the domestic and the foreign business of respondent. Managerial powers strictly circumscribed by territorial limitations do not satisfy the concept of place of management. It is the purpose of this criterion to fix a center of gravity of the corporate affairs, one place wherefrom activities are directed for the corporation as a whole. This center being in Germany subjects a corporation as a whole to unlimited tax liability. There is no basis in the record to find such a center in Germany. We need not decide whether such management has its place in Austria or is unascertainable. However, in so far as the Tax Court did not discuss the issue of limited tax liability of respondent, we must reverse and remand.

Reversed and remanded.

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261. BFH March 1, 1966, [1966] BSTBl 207.

## Appendix B

### *Decision I 230/615*[262]

Appellant was incorporated in Japan, having its seat and place of management in Tokyo. The German corporation K in Berlin owns 99 percent of appellant's shares.

For the year 1958 the Revenue Service imposed an unlimited corporate income tax on appellant in applying § 15 II StAnpG after acquiring the necessary information from the parent K.

The parent corporation, representing the interests of appellant subsidiary before the Tax Court, advanced the following arguments: § 15 II StAnpG is unconstitutional because it is in conflict with the generally accepted law of nations which in turn is superior to domestic German law according to Art 25 GG. Taxing a foreign subject without adequate contacts in Germany such as residence or abode or capital or income or other tax bases is a violation of the territorial principle under international law. Furthermore, § 15 II is a product of the presumption of the Nazi-government in attempting to prohibit the transfer of profits within international combines. Such policy could be implemented at best by taxing the German company, but on no account by reaching the foreign subsidiary not being subject to German Tax jurisdiction. The management of appellant consists of two German citizens who are residents of Japan and have no contractual or personal connections to the parent K in Germany.

The Tax Court held that § 15 II was constitutional and that appellant was liable for the corporate income tax, but entitled to credit the taxes paid to Japan.

The Secretary of the Treasury, as intervenor, has submitted the following arguments to us: There are no generally accepted rules of international law violated by § 15 II.

Not only Germany is engaged in attempts to reach income of foreign corporations under certain circumstances. Besides, the very existence of § 15 II of our tax law is an indicium of lack of generally accepted principles on the subject. Under the law of nations, there is no single test for what constitutes sufficient contact to justify tax jurisdiction. There is no rule prohibiting multiple tax jurisdiction on the same facts. The existence of tax treaties is a good example of coexistence of different jurisdictional approaches and of the attempts made by different states to solve the inherent international conflicts. At any rate, there is no discriminatory or arbitrary taxation in § 15 II since the taxpayer's contacts with Germany are no doubt sufficient. It is true, corporations falling into the scope of § 15 II are foreign corporations. However, these corporations are to such a degree dominated by a German enterprise that they are in economic effect merely operating divisions of the domestic person. A contact like that is at least as important as is seat or place of management in Germany. As a matter of fact it seems rather of secondary significance that the executives of appellant reside abroad, when compared with the fact that appellant is economically not independent but integrated with the dominant economic unit resident in Germany. Besides, even without the existence of § 15 II we could find the place of management in many cases at the place of management of the dominant domestic enterprise. Under such circumstances it is a defensible technique under international law to avoid complex inquiries on the location of the place of management by establishing a fiction or an absolute presumption. In this context it may be of interest that not only the law of corporate taxation but also the law of corporate nationality contains no exclusive rules on connective factors. The controlling national laws in the latter area use either the seat principle or the incorporation principle or the principle of factual control. The control principle being internationally accepted in this field, the application of the same idea by establishing the rule of § 15 II cannot be a violation of the

262. BFH December 18, 1963, [1964] BStBl 253.

law of nations because § 15 II is practically the adoption of the control principle for purposes of international taxation. The fact that the law in issue was passed in 1934 does not necessarily make it an expression of Nazi ideas. The policy of the act was equal treatment of legally independent and legally dependent foreign permanent establishments of domestic enterprises. Moreover, the tax law of the United Kingdom has adopted principles similar to § 15 II. Since other laws take similar approaches the possibility of a violation of international law by § 15 II is excluded.

Appellant has presented to us the expert opinion of Prof. Dr. B who inter alia states: Using a fiction as such makes § 15 II not invalid under international law. However, the provision in question violates the international principle of reciprocal respect of different nation's taxing power insofar as it taxes on world-wide basis a foreign corporation being subject to full tax liability to its home state without any consultation with the foreign authorities. While not invalid because it originated in the Nazi period, the provision is not feasible in administrative practice, as the very rare application by the Revenue Service shows. §15 II is based on the German tax law theory of financial, organizational and economic integration (Organschaft). This theory, however, could not find acceptance by the international community of taxing states. Judged by the standards incorporated in modern tax treaty law, § 15 II cannot be deemed valid. If treaties, based on reciprocal bilateral agreements, have generally adopted the principle of not treating the dependent foreign subsidiary as a permanent establishment of the domestic parent, such treatment as established by the unilateral German measure must be considered as internationally outlawed. Finally, in according to a foreign person having no permanent establishment within Germany the status of a resident by means of a fiction, the German legislature inadmissably transcends its sovereignty. Such an expansion of the domestic taxing power to the territory of a foreign state is only acceptable with the consent of the foreign state. At the same time, the selective application of the provision challenged constitutes a violation of the principle of non-discrimination and equal treatment of taxpayers fundamentally imbedded in our tax law.

Appellant cannot succeed in its appeal before us. It is a principle of our constitutional law that generally accepted rules of the law of nations are superior to domestic law. Such a norm of international law that would take precedence over the challenged provision of § 15 II would read: A corporation having its seat and place of management abroad and having legal independence under foreign law may not be treated as an economically integrated and separately operated part of a domestic enterprise. We are aware of no such principle of international law. We follow Bühler/Strickroth (Steuerrechts I, 3ed. p 146) when they state that there is as yet no general international law so far as the taxation of international transactions and relations is concerned.

The expert opinion is correct in assuming that § 15 II creates a personal domestic tax liability for the foreign corporation. However, we must regard the reasons for such liability. It is the dependence on the domestic enterprise, the economic integration that constitutes the requisite contact that justifies the exercise of the domestic taxing power. It is not the legal fiction of domestic place of management, but it is the economic reality that justifies the taxation of the foreign corporation. The integrated appellant corporation, dominated financially, organizationally and economically, virtually overpowered by the 99 percent shareholder domestic corporation, may be independent from a legal point of view, but a sufficient contact justifying Germany's taxation cannot be disputed. In economic terms, appellant is managed by the domestic parent. It should also be noted that no undue hardship exists as long as the established tax credit takes care of the double taxation.

It is true that the application of the provision in question encounters considerable administrative difficulties. However, there is no principle of international law that would impair the validity of a unilateral tax measure because of complexities of enforcement.

We concede that the German theory of integration (Organschaft) did not find its way into the tax arsenal of other nations. This does not mean that the theory as such is in conflict with international law, all the more so as the integration clause was embodied in the German-Italian treaty (1925) and the French-Italian treaty (1930). The theory of integration has been criticized in the past and seems to have gained support in recent international development, as Rädler pointed out (StW 1963/283). But these positions are irrelevant when it comes to the question whether or not § 15 II collides with the international conception of fiscal sovereignty and the principle of territoriality. It is up to the state to restrict its taxing power reasonably, though there is no limitation under the law of nations. Every state shapes its tax law according to its various policy considerations. Overlapping tax jurisdictions of different states have no impact on the validity of the adopted provisions, which may be mitigated by international tax conventions.

Contrary to the contention of the Secretary of the Treasury, the expert opinion is correct in stating that the American Revenue Bill of 1962 and the British Finance Act of 1957 avoid imposing a tax upon the foreign corporation directly. It is the domestic corporation that is reached by their taxing power. However, this is not evidence of an international norm prohibiting direct taxation of a foreign subsidiary.

The argument concerning equal protection is equally unfounded. There is no proof that the statute was not applied to certain integrated corporations. The Treasury ruling of October 25, 1939, providing for non-application of § 15 II in certain cases of particular hardship, was repealed on January 1, 1957, since it had lost its basis after the adoption of the unilateral tax credit system.

Finally, both the Secretary of the Treasury and the expert opinion are right when explaining that the statute in issue does not express any Nazi policies.

In conclusion, the challenged provision is valid and applicable to the instant case. Affirmed.

# DRAFTING A BILL IN BRITAIN

ARNOLD KEAN*

In contrast to the American practice, modern statutes in Great Britain do not bear the names of members of Parliament who promoted them. Our Tafts and Hartleys, our Norrises and LaGuardias are obliged to seek their monuments elsewhere, since draft bills are almost invariably the work of the civil service. The driving-wheel of this machinery is the Office of Parliamentary Counsel to the Treasury, a select group of specialists in legislative draftsmanship.

## EXECUTIVE CONTROL OF THE LEGISLATIVE PROCESS

The American reader may want to know why it is that the individual member of Parliament is so rarely the originator of a major statute.[1] The explanation lies in the predominance of the executive in modern British constitutional history. In the United Kingdom, the doctrine of the separation of powers died a natural death before, or soon after, it was born. After the Civil War in the seventeenth century, the King could govern only with the consent of those having the confidence of the majority of the House of Commons. In the eighteenth century, this developed into the system of Cabinet government. The executive consists, in effect, of a committee of the legislature, to the lower House of which it is responsible. The expansion of the electorate in the nineteenth and twentieth centuries and the development of mass media of communication ultimately created the modern pattern of disciplined parties.

In the modern era the legislation enacted by Parliament is almost entirely a Government product. The Ministers of the Crown, who form the Government, are invariably members of the Commons or the Lords. The remaining members of the majority party in the House of Commons, the "Government back-benchers," are subject to party discipline imposed by party whips, which in practice is sufficient to ensure the passage of Government-sponsored legislation in the House of Commons. (The Lords have only a limited delaying

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1. Occasionally, however, the Government will be sympathetic to the aims of a private member's bill, and will facilitate its passage by providing "time" in the House of Commons for the stages through which it must go.

power.) Private members' bills are allotted very little parliamentary time for debate, and even this limited time must be shared out among them by ballot. The Government's power over the legislative process is such that a bill has little chance of reaching the statute book unless it is one introduced by the Government.[2]

## The Civil Service

Many functions which would be performed in the United States by political appointees are in Britain the tasks of civil servants.[3] A few words about the British civil service are therefore in order.

The senior class of the British civil service is the administrative class. The British administrative civil servant is normally recruited in his early twenties and expects his whole career to be in the civil service. In practice he can be removed only for misconduct, and his position is not affected by political vicissitudes. Indeed his party predilections, if he has any, usually remain unknown, and it is his duty to advise Ministers of the Crown and to give effect to their decisions whatever their political implications. The same civil service can manage the nationalisation of steel under a Labour Government, its denationalisation under a Conservative Government, and its re-nationalisation under Labour again. The individual civil servant acts, as it were, as an extension of the Minister he serves, putting at the Minister's disposal the administrative skills and knowledge acquired during his career in the service.

The administrative class of the civil service is traditionally an elite of non-specialists. The distrust of formal professional education dies hard in England.[4] The theory has been that an intelligent classicist,

2. Some recent successes of private members' bills should, however, be noted. Abolition of capital punishment, and reform of the laws relating to abortion and homosexual offences were all championed by individual M.P.'s. The Government took no position on these bills and allowed a free vote (*i.e.*, the whips were withdrawn).

3. In the United States an incoming administration has about 1100 "political executive" positions to fill. *See* M. Bernstein, The Job of the Federal Executive (1958).

4. Not only in the field of public administration. Even law students are given a "non-professional" education; they are given only a basic academic background, *e.g.*, Roman, international, and constitutional law, jurisprudence, legal history, torts, contracts, and criminal law. This is followed by three years of apprenticeship (articled clerkship) for budding solicitors and by further studies for the bar and a year's pupilship for budding barristers. Harvard Law School was founded as an alternative to the "necessarily deficient" mode of education by apprenticeship. See the comment by Isaac Parker, first Royall Prefessor of Law, in a letter

historian, philosopher or the like, with three years undergraduate work at a university, can pick up all the technical expertise he needs by a proper apprenticeship to another administrator, similarly educated but more experienced. The enlightened young amateur is allowed to try his hand at six- to twelve-month stints in different branches of the same department, to prepare him for eventual responsibility higher up. If he is also a lawyer, economist, political scientist, or other professional, he is one only by accident, since no professional qualification is required for the job.

Only recently has it been realized in the British civil service that the apprenticeship system may not be adequate for training an administrator for modern technical tasks. Some young administrators today are therefore sent for professional training to universities, for example, to the business schools newly founded at London and Manchester Universities. Perhaps the most interesting new experiment is the Treasury's Centre for Administrative Studies, on the eastern fringe of Regent's Park. The elegant nineteenth-century architecture of the building is belied by the activities inside, which include a twenty-week intensive course in economics, statistics, and decision theory. All administrative recruits receive this course as well as a three-week course in general governmental matters, including four half-day sessions on the preparation of a bill.

## PARLIAMENTARY COUNSEL TO THE TREASURY

Before the nineteenth century there was no central drafting office. Bills were mostly drafted by private members of Parliament, though at times important bills were settled by the judges. In 1798, William Pitt, the Prime Minister and First Lord of the Treasury, appointed as a government draftsman one William Harrison, who is said to have worked "very hard" for a few years without any salary. By 1833, Harrison had achieved a salary and the title of Parliamentary Counsel to the Treasury. Harrison's post seems to have lapsed in 1837, and for some time most important Government bills, originating in any Department of the Government, were prepared by the Home Secretary, who felt the need to employ a lawyer for the purpose. But, in those days before the development of modern party discipline, much

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to President Kirkland and the Fellows of Harvard University, May 14, 1817, 1815-1819 HARVARD COLLEGE PAPERS, at 47 (8); C. WARREN, 1 HISTORY OF THE HARVARD LAW SCHOOL 305 (1908), *cited in* A. SUTHERLAND, THE LAW AT HARVARD 54 (1967).

major legislation was still introduced and carried by private members. In the 1860's, as the volume of Government-sponsored legislation began to mount steeply, Departments other than the Home Office found it necessary to employ their own counsel for bill-drafting, or even to draft bills without legal aid.

This system was patently unsatisfactory. Barristers employed "by the job" were entitled to high fees. There was no uniformity of language, style, arrangement, or even of principle, in the resulting statutes. There was no way to coordinate or reconcile the different bills introduced by the different Departments, and nothing prevented a Departmental bill from authorizing expenditure from the Exchequer in such a way as to upset the Chancellor's Budget calculations.[5]

In 1869 the Chancellor of the Exchequer created an office within the Treasury for the centralised drafting of Government bills. It was created by Treasury minute, and not by or under any Act of Parliament, reflecting the central position of the Treasury as the coordinating Department not only of national finance but of the civil service as a whole. Until recently, it was necessary for other Departments to obtain the formal approval of the Treasury for the employment of Parliamentary Counsel.

Parliamentary Counsel to the Treasury are salaried civil servants recruited after some years of practice as barristers. At present they are eighteen in number, and the First Parliamentary Counsel is invariably one of the most distinguished and influential of government lawyers.

Parliamentary Counsel can only give effect to the legislative policy expressed in the instructions he receives from the Department sponsoring the bill. As is the custom in England, counsel cannot be instructed by laymen but only by a solicitor, in this case by the solicitor to the Department concerned. The solicitor supplies legal expertise in the specialised field and coordinates the Department's work on the bill. It is his duty to reduce the Department's policy to a request for changes in the law, which he incorporates in his Instructions to Parliamentary Counsel. The solicitor does not suggest wording for the bill; it is counsel's job to devise wording to give effect to the Instructions he receives. In so doing, counsel can be assured that the Minister will not put down any amendments in the House unless they have been drafted by counsel, and that the Minister will resist amend-

5. For this early history, I am indebted to SIR COURTENAY ILBERT, LEGISLATIVE METHODS AND FORMS ch. v. (1901).

ments put down by others unless this wording is satisfactory to counsel. For this purpose the Parliamentary Counsel, or his assistant, must be present during Parliamentary discussion of amendments to the bill, either at the Minister's elbow in Standing Committee or in the official box in the House. The draftsman will also derive comfort from the knowledge that British courts, unlike their American brethren, refuse to examine Parliamentary debates in construing a statute, but ascertain Parliament's intention from the wording of the statute. The expert draftsman can thus leave his mark in the clarity and precision of the resulting Act.

## FORMULATION OF POLICY

The policy of the bill, of course, originates in the political process. Important policies may have formed part of the election manifesto on which the Government was elected (*i.e.*, what Americans would call a "platform"). A policy decision will often be the result of months or years of discussions within the Government and consultation with bodies representative of the outside interests that may be affected. The policy will then be worked out by administrative civil servants under the general direction of the Minister. The administrators will scrutinize their solicitor's draft Instructions to Parliamentary Counsel to make sure that their policy is accurately represented, and with their solicitor's assistance they will examine the resulting draft bill to see that it is satisfactory. The administrators, again with assistance from their Departmental solicitor, will brief the Minister for discussion of the bill in Cabinet and later for debate in Parliament.

These are difficult and important functions for administrative civil servants to perform, even though Parliamentary Counsel do the actual drafting. Consequently the Treasury Centre for Administrative Studies has for the first time undertaken to train young administrators (Assistant Principals) in the preparation of a bill. The trainees become familiar with all the stages and documents involved in the process of translating policy into legislation.

Typically these documents include: (1) a document outlining the policy as approved by the Cabinet, (2) the Departmental solicitor's Instructions to Parliamentary Counsel, (3) a draft bill, (4) an explanatory letter from Parliamentary Counsel to the Departmental solicitor, accompanying the draft bill, (5) any amendments to the bill proposed by Government or Opposition or by back-benchers on either side of the House, (6) Notes on Amendments, prepared by the administrators for the guidance of the Minister, (7) an Explanatory and Financial Memorandum, printed with the bill upon its introduction into Parliament, (8) a Ministerial memorandum to the Cabinet, which accompanies the bill when Cabinet approval is sought for its introduction, and (9) Notes on Clauses, a commentary on the bill for the guidance of the Minister and for the general use of the Department.[6]

## Special Problems of Legislation in Britain

*British "federalism"* — When a bill receives the royal assent, it becomes a Statute of the United Kingdom, that is to say, England and Wales, Scotland and Northern Ireland. It will apply to the whole of the United Kingdom unless there is a specific provision in the Act to the contrary. For example, if the Ministry of Labour is the sponsor of a bill, the Act will be likely to apply to Scotland as well as England and Wales, because that Ministry has responsibility for Scotland. Some legislation in other fields, on the other hand, may have to exclude Scotland, or apply only to Scotland (a Scottish Act), because of differences in the legal, administrative and educational systems of England and Scotland. England and Wales are historically a single unit for legal purposes.

Northern Ireland, however, has its own Parliament in Belfast (Stormont), which has power over internal affairs. Any legislation from Westminster interfering with Stormont's jurisdiction could not be held unconstitutional by a court, there being no court with jurisdiction to review an Act of the United Kingdom Parliament. But it would amount to an amendment to the Government of Ireland Act, 1920,[7] and could be unacceptable from the constitutional viewpoint. Therefore the draftsman of any such bill would be alert to exclude Northern Ireland from the application of the bill.

There is a related problem in respect of the Channel Islands and

6. This writer takes part in the training project in legislative preparation at the Treasury Centre for Administrative Studies. Actual documents relating to actual bills are protected by Cabinet secrecy, but the Treasury have kindly given permission for the mock documents used in the Centre's training exercise to be made available. A set of the documents may be obtained from this writer, or examined in the files of the Harvard Student Legislative Research Bureau.

7. 10 & 11 Geo. 5, c. 67.

the Isle of Man, which are subject to the Crown but not part of the United Kingdom. Here the typical bill will include a clause enabling Her Majesty by Order in Council to extend the Act to the territories in question, with any adaptations, modifications, or exceptions set forth in the Order. (Normally the approval of the Government of the territory would in practice be obtained, though it is never required by law). Similarly the bill may provide for its extension by Order in Council to colonies and other dependent territories overseas.

*Subordinate legislation* — Because the Government enjoys the confidence of a majority of the House of Commons, Parliament finds it sensible to delegate a limited degree of legislative power to the executive. The young administrators are taught at the Treasury Centre that Parliament's time is an increasingly precious commodity, and that Parliament itself has no relish for detailed legislation on matters of little political importance. In consequence, a substantial part of many a bill is an enabling enactment, conferring on the Crown or on a Minister the power to make detailed regulations. These executive orders, called "subordinate legislation," may take the form of an Order in Council, (a form used only for weightier matters affecting more than one Department) or of an Order, Rules or Regulations, if the power is delegated to a Minister.[8] Either form of subordinate legislation will be by Statutory Instrument and will be void to the extent that it is ultra vires the authority conferred by the parent statute, a point that can be tested in the courts. Thus there is a possibility of judicial review of subordinate legislation although not of an Act of Parliament.

Either form of subordinate legislation, unless the matter is only of minor importance, is likely to be subject to Parliamentary scrutiny. The most usual device is the negative resolution, which, if passed by either House, requires the revocation of the order or regulation. More important orders or regulations may be laid before Parliament in draft and not made until each House has passed an affirmative resolution. There are other variants. These procedures have in common the rule that Parliament can accept or reject subordinate legislation but cannot make amendments to it; also that all statutory instruments of general application are now referred to the Commons'

8. For an example of an Order in Council, see the Air Navigation Order, STAT. INSTR. 1966, No. 1184, made under section 8 of the Civil Aviation Act, 1949, 12, 13 & 14 Geo. 6, c. 67. For an example of Ministerial Regulations, see the Merchant Shipping (Fees) Regulations, STAT. INSTR. 1967, No. 1611.

Select Committee on Statutory Instruments.[9] The Select Committee's terms of reference include reporting to the House upon any defects in drafting and "any unusual or unexpected exercise of a power," a frequent victim of the Select Committee being any subordinate legislation which subdelegates a power without specific authorization in the parent statute.

*The British Statute Book* — The oldest unrepealed statute is a Distress Act of 1267, part of the Statute of Marlebridge.[10] It would be erroneous to infer that the concepts and procedures of our law are still medieval. Nevertheless the Statute Book, like the common law, still abounds in deadwood. In consequence, a new instrument has been devised for the systematic reform of the law, under a programme approved by the Lord Chancellor. Under the Law Commissions Act 1965,[11] the Lord Chancellor appoints a five-member Law Commission, the present Chairman of which is one of Her Majesty's Judges. The other current members include a former Director of the Institute of Comparative Law, and an authority on Continental law, the Commission thereby avoiding an insular outlook. There are nineteen lawyers on its staff, including four draftsmen seconded from the office of Parliamentary Counsel.

It is too soon to judge the quality or quantity of the Commission's work, whether in law reform, codification of the common law, or consolidation of statutes, but it will be their task to produce a flow of draft bills for introduction into Parliament. These may be expected to deal mostly with lawyers' law, because it is generally recognized in the United Kingdom that national policy cannot effectively be dealt with by non-political bodies, however expert.[12] The bills produced by the Law Commission will be drafted by the Parliamentary Counsel seconded to their service. The activities of the Commission are of course quite separate from those of the Departmental administrators

9. A change was made in the Committee's terms of reference for the Session 1967-8. Previously the Committee could scrutinize only those Instruments which were required to be laid before Parliament, and defects in drafting were not within their purview.

10. 52 Hen. 3, c. 1. *See* HER MAJESTY'S STATIONERY OFFICE, INDEX TO THE STATUTES IN FORCE (1967). A chapter of the Statute of Merton, the oldest statute recorded, 20 Hen. 3, c. 4 (The Commons Act, 1236) was repealed only as recently as 1953. HER MAJESTY'S STATIONERY OFFICE CHRONOLOGICAL TABLE OF THE STATUTES (1967).

11. 1965 c. 22.

12. For a study of this phenomenon, see H.W.R. Wade, *Anglo-American Administrative Law: Some Reflections*, 81 L. Q. REV. 357.

and solicitors discussed in this paper, though there is necessarily a great deal of consultation with them. The greatest part of the British Statute Book will, one may predict, continue to be derived from bills prepared in Government Departments, the expert (dare we say professional?) product of the civil servants who sit in the official box, to the right of and somewhat behind the Speaker's chair in the House of Commons.

# HARVARD STUDENT LEGISLATIVE RESEARCH BUREAU
## 1967-68



## Harvard Journal on Legislation

# NOTE: TAX ADJUSTMENTS FOR ECONOMIC STABILITY AND GROWTH: PROPOSALS FOR REFORM OF THE LEGISLATIVE PROCESS

*[T]o tax and to please, no more than to love and to be wise, is not given to men.*

—Edmund Burke, Speech on American Taxation, 1774.*

## I. Introduction: Taxation and Fiscal Policy

It is an axiom of the "New Economics" that federal taxation can be a means of ensuring economic stability, growth, and full employment.[1] Most tax changes made for such purposes are short-run measures; they are concerned not so much with the distribution of the tax burden or with any long-term social policies reflected therein, but with the short-run tactics of keeping the economy on the path of stable growth. For this task, the promptness of tax legislation is of the essence.

The object of this Note is to examine and evaluate the process of legislating tax measures in the United States Congress. Recent proposals for expediting or bypassing the current legislative procedure will be examined, along with some of the economic, political, and constitutional issues which they raise.

The efficiency of the tax legislative process is becoming increasingly important because of the greater reliance that is now placed on taxation, as opposed to government expenditure, as an instrument of fiscal policy. Although a change in expenditure will have a greater multiplier effect on aggregate demand than will a change in tax rates,[2] it is felt that public expenditure is better guided by long-run social purposes than by the vicissitudes of short-run stabilization policy. The efficiency of public expenditure is impaired when projects are halted abruptly before completion or accelerated without adequate

*Selected Writings of Edmund Burke 96 (W. J. Bate ed., 1960).

1. *See, e.g.,* Council of Economic Advisers, *Annual Report,* in Economic Report of the President 1962, at 70-84; D. Ott & A. Ott, Federal Budget Policy 60-69 (1965). For a discussion of sections of the Internal Revenue Code of 1954 which have economic-policy purposes see Briggs, *Taxation Is Not for Fiscal Purposes Only,* 52 A.B.A.J. 45 (1966).

2. J. Pechman, Federal Tax Policy 10-11 (1966).

preparation.[3] While there is a substantial time lag between the government's decision to spend and the ultimate effect on national income, tax rates can be altered quickly, and a change in the rates of personal income tax has an immediate impact on disposable income through the withholding system.[4]

Rapid tax-rate changes can also be used to alleviate "revenue drag," which results from the so-called automatic stabilizing effect of the income tax. When incomes are rising, the fixed statutory rates of income tax draw increasing amounts of revenue into the Treasury.[5] This by itself would dampen the rate of growth of national income. Conversely, when incomes are falling, the absolute decline in tax revenues would tend by itself to leave the budget in deficit (assuming expenditure remains constant). The excess of expenditure over revenue would then have an expansionary effect.[6]

Such a stabilizing mechanism is welcome as a floor under recession and as a ceiling on inflation, but it has its disadvantages. First of all, if inflationary forces are too strong (as in a war-stimulated boom), the automatic restraint may be insufficient and a change in rates may be needed. Secondly, in more normal circumstances, the restraint on upward movement tends to impede the non-inflationary expansion of the economy toward full employment. In other words, the brake is applied too soon.[7] Thirdly, the restraint on upward movement is also a permanent restraint on the economy's growth.[8] In short, rapid changes in the tax rates are essential not only for leveling out the business cycle, but also for attaining full employment and for keeping the economy on the path of steady growth.

## II. The Tax Legislative Process

In the spring of 1966, as the "fine mist of incipient inflation [was]

3. Council of Economic Advisers, *Annual Report,* in Economic Report of the President 1966, at 184; R. Musgrave, The Theory of Public Finance 503 (1959).

4. *See* note 164 *infra.*

5. The progressive nature of the rates is not the source of this increase in revenue. Even though many taxpayers move into higher brackets when overall income rises, many others are brought into the tax base for the first time, and at the lowest rates. This keeps the average effective rate fairly stable. R. Goode, The Individual Income Tax 289, 291 (1964).

6. On the "built-in flexibility" provided by the "automatic stabilizers" see N. Keiser, Macroeconomics, Fiscal Policy, and Economic Growth 373-74 (1964) [hereinafter cited as Keiser]; R. Goode, The Individual Income Tax 286-301 (1964).

7. Council of Economic Advisers, *Annual Report,* in Economic Report of the President 1963, at 68.

8. W. Heller, New Dimensions of Political Economy 65 (1967).

turning into light rain,"[9] American economists watched in awe as the Canadian government executed a swift tax increase.[10] The parliamentary system in Canada guaranteed that the government's tax proposal was enacted without significant modification. The tax measure was kept secret until announced in the Budget, and when passed by Parliament it was retroactive to Budget Day. "To put it in a nutshell, the President of the United States or the Secretary of the Treasury proposes taxes, whereas the Minister of Finance announces them."[11] In Walter Heller's words, the flexibility, speed, and selectivity of the Canadian action in 1966 "made the U. S. political economist's mouth water."[12]

In the American system, the Congress is in full control over the tax legislative process from the moment the President makes a proposal.[13] By custom, the Administration submits only recommendations for tax legislation, instead of a draft bill.[14] These recommendations are formulated in the Treasury Department, usually with the participation of the Bureau of the Budget and the Council of Economic Advisers.

The proposals are then sent to the House of Representatives,[15] which transfers them immediately to the Committee on Ways and Means. This 25-member committee usually holds public hearings, which last until all interested governmental and private parties are heard from. The hearings will be long if there is opposition and controversy. For example, the Revenue Act of 1964[16] required eight weeks of hearings; in contrast, the Excise Tax Reduction Act of 1965[17] required no hearings at all.

9. Walter W. Heller, former Chairman of the Council of Economic Advisers, *quoted in* N. Y. Times, March 17, 1966, at 22, col. 2.

10. A 1965 tax deduction of 10% was removed, and a refundable tax was imposed on corporate "cash flow," that is, profits plus depreciation and depletion allowances. Income Tax Act of 1966, c. 47, §§ 4, 11 (Can.).

11. R. BERTRAND, A DESJARDINS, & R. HURTUBISE, LEGISLATION, ADMINISTRATION AND INTERPRETATION IN FEDERAL TAXATION 44 (Study for the Royal Commission on Taxation No. 22, 1964).

12. W. HELLER, NEW DIMENSIONS OF POLITICAL ECONOMY 103 (1967).

13. The standard work is R. BLOUGH, THE FEDERAL TAXING PROCESS (1952). See also HARVARD UNIVERSITY LAW SCHOOL, INTERNATIONAL PROGRAM IN TAXATION, WORLD TAX SERIES: TAXATION IN THE UNITED STATES § 1/5.2 (1963).

14. 20 CONG. Q. ALMANAC: 88TH CONG., 2D SESS., 1964, at 526 (1965).

15. *Cf.* U.S. CONST., art. I, § 7: "All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills."

16. 78 Stat. 19.

17. 79 Stat. 136.

The Ways and Means Committee, in executive session, with the assistance of the technical staff of the Joint Committee on Internal Revenue Taxation,[18] then draws up a bill and reports it out to the whole House. Little time is taken up with floor debate in the House, for tax bills are debated under a "closed rule," which imposes a time limit and allows no amendments except those approved by the Committee.[19]

After House passage, the bill is sent to the Senate, which transfers it immediately to the Committee on Finance. Hearings take place again, usually with the same parade of witnesses, who now have the particular details of a bill on which to focus their complaints or endorsement. The Finance Committee may make great changes in the House version of the bill.[20] In 1964, for example, the Committee reported out 25 major amendments to the House version of the Revenue Act and added over $1 billion to the estimated tax reduction.[21]

Floor debate in the Senate is the only stage in the tax legislative process where the Administration, if need be, can attempt to mobilize its forces against the power of the committees and their chairmen, or against changes made in its recommendations by the House. Nevertheless the Senate's tradition of unrestricted debate is often a source of delay. Senate debate on tax measures is not subject to any closed rule; members may speak without time limit and may propose further amendments, which need not even be germane. The 1967 Act to restore the investment credit and accelerated depreciation[22] was delayed almost two months in the Senate, after having passed the House in a week. The Senate spent five weeks debating an amendment by Senator Albert Gore relating to the financing of presidential campaigns.[23]

The bill, when finally passed by both Houses after a Senate-House conference, may be very different from what the Administration pro-

18. The organization and functions of the Joint Committee are set forth in INT. REV. CODE of 1954, §§ 6405, 8001-05, 8021-23, and described in Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted,* 70 HARV. L. REV. 1145, 1166-70 (1957).

19. HARVARD UNIVERSITY LAW SCHOOL, INTERNATIONAL PROGRAM IN TAXATION, WORLD TAX SERIES: TAXATION IN THE UNITED STATES 89 (1963).

20. *Cf.* note 15 *supra.*

21. SENATE COMMITTEE ON FINANCE, REPORT TO ACCOMPANY H.R. 8363, H.R. REP. No. 830, 88th Cong., 1st Sess. 9-11, 13 (1964).

22. Pub. L. No. 90-26 (June 13, 1967).

23. 25 CONG. Q. WEEKLY REP. 775-79 (No. 19, May 12, 1967). The Gore Amendment was submitted early in April. *See* 113 CONG. REC. S4459 (daily ed., April 3, 1967).

posed. In 1967, for example, the Act to restore the investment credit and accelerated depreciation (which had been suspended in 1966) was more bountiful than the Administration had intended; the Congress made certain of the bill's liberalizing provisions retroactive, nullifying part of the effect of the suspension.[24]

The tax legislative process in the United States is thus a reflection of the American political system, which distributes policy-making functions among separated institutions. It is therefore not surprising that too many cooks often spoil the integrity, consistency, and timing of federal tax policy.

Since timing of short-run tax policy is especially important, delay can render a tax measure ineffective, or even perverse (if, for example, a tax increase falls on an economy which has passed an inflationary peak and has already slowed down). It is only since 1962 that federal tax policy has been governed by conscious Keynesian motives.[25] But the tax legislative process has functioned no more expeditiously since that date than before. Table I shows the lengths of time required for the passage of major federal tax bills since 1948. The record of performance is mixed. The Excise Tax Reduction Act of 1965 required only one month between presidential message and presidential signature. Only two months were needed to pass the Tax Adjustment Act of 1966[26] (which accelerated the withholding and prepayment of individual and corporate income taxes). Only two months were required to enact the 1966 Investment Credit and Accelerated Depreciation Suspension Act.[27] At the opposite pole, the Revenue Act of 1962[28] (which created the investment credit) required 18 months for

24. The Administration sought to restore the credit for property *ordered* after the effective date of the restoration, property *acquired* after the effective date (except if ordered during the suspension period), and construction *begun* after the effective date. The Act as signed by the President allowed the credit for property *delivered* after the effective date (even if ordered during the suspension period), and for any portion of construction *completed* after the effective date (even if begun during the suspension period). *Compare* the President's Message on Fiscal Policy and Stable Growth, Sept. 8, 1966, in 2 WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS 1248, 1250 (No. 51, Sept. 12, 1966) *with* Pub. L. No. 90-26 (June 13, 1967).

25. KEISER, *supra* note 6, at 512-14; W. LEWIS, FEDERAL FISCAL POLICY IN THE POSTWAR RECESSIONS 17-18 (1962) [hereinafter cited as LEWIS]; Ture, *Limitations on the Use of Anti-Recessionary Tax Policy*, 44 VA. L. REV. 949, 951 (1958). *Cf.* Remarks of President John F. Kennedy at Yale University, June 11, 1962, in PUBLIC PAPERS OF THE PRESIDENTS OF THE UNITED STATES: JOHN F. KENNEDY 1962, Item [234] 470 (1963) [hereinafter cited as KENNEDY PAPERS 1962].

26. 80 Stat. 38.

27. 80 Stat. 1508.

28. 76 Stat. 960.

passage, and the Revenue Act of 1964 (the $11 billion income tax reduction) took thirteen months. An economist contemplating a countercyclical tax measure could only agree with the Thane of Cawdor that:

"If it were done when 'tis done, then 'twere well
It were done quickly."[29]

TABLE I: LEGISLATIVE HISTORY OF MAJOR FEDERAL TAX BILLS, 1948-1968*

| TITLE OF ACT | Date of President's Message | Date of House Passage | Date of Senate Passage | Date of Enactment | Months Elapsed |
|---|---|---|---|---|---|
| Revenue Act 1948 | [a] | 2/2/48 | 3/22/48 | 4/2/48[b] | 3[c] |
| Revenue Act 1950 | 1/23/50 | 6/29/50 | 9/1/50 | 9/23/50 | 8 |
| Excess Profits Tax Act 1950 | [d] | 12/5/50 | 12/20/50 | 1/3/51 | 3 |
| Revenue Act 1951 | 2/2/51 | 6/22/51 | 9/28/51 | 10/20/51 | 8 |
| Internal Revenue Code 1954 | 1/21/54[e] | 3/18/54 | 7/2/54 | 8/16/54 | 7 |
| Excise Tax Reduction Act 1954 | [a] | 3/10/54 | 3/25/54 | 3/31/54 | 2[c] |
| Federal Aid Highway Act 1956 | 2/22/55 | 4/27/56 | 5/29/56 | 6/29/56 | 16 |
| Revenue Act 1962 | 4/20/61[f] | 3/29/62 | 9/6/62 | 10/16/62 | 18 |
| Revenue Act 1964 | 1/24/63 | 9/25/63 | 2/10/64 | 2/26/64 | 13 |
| Excise Tax Reduction Act 1965 | 5/17/65[f] | 6/2/65 | 6/15/65 | 6/21/65 | 1 |
| Tax Adjustment Act 1966 | 1/24/66[e] | 2/23/66 | 3/9/66 | 3/15/66 | 2 |
| Investment Credit and Accelerated Depreciation Suspension Act 1966 | 9/8/66 | 9/30/66 | 10/14/66 | 11/8/66 | 2 |
| Restoration of Investment Credit and Accelerated Depreciation Act 1967 | 3/9/67 | 3/16/67 | 5/9/67 | 6/13/67 | 3 |
| Income Tax Surcharge 1968 | 8/3/67[f] | ? | ? | ? | ? |

a = Not recommended by President.
b = Passed by Congress over presidential veto.
c = Time elapsed from date of first consideration by Ways & Means Committee.
d = No special presidential message. Revenue Act 1950 directed tax committees to report tax retroactive to July 1 or October 1, 1950.
e = Recommended by President in Budget Message.
f = Recommended initially by President in Budget Message in January of year indicated.

*Adapted, with additions, from J. PECHMAN, FEDERAL TAX POLICY 32, Table 3-1 (1966).

29. *Quoted in* W. SHAKESPEARE, MACBETH I:vi, at 1-2 (1606).

## III. Proposals for Reform

The checkered history of recent tax legislation casts doubt upon the reliability of the traditional procedure for enacting tax laws. Three different techniques of reform have therefore been suggested for ensuring the timeliness and consistency of short-run tax changes. The first is *presidential discretionary authority*. By this method, the President decides on a tax change, which then goes into effect within, say, thirty days; but an enabling statute will have laid down the rules for the exercise of presidential discretion, and Congress retains the power to veto the measure by joint resolution within the thirty days. The second proposal is *congressional standby legislation*. The essential point of this method is that Congress performs the positive function of enacting a specific tax change, rather than the negative one of veto, but with the rationale, format, and procedure of a standardized tax measure having been prearranged. The third device is *formula flexibility*, which would vary tax rates automatically according to the movements of certain prescribed economic indicators. Once the formula scheme is in force, no decision by either President or Congress is required for the execution of short-run tax policy.

### *A. Presidential Discretionary Authority*

#### 1. The Proposal

The only serious effort made by a President to effectuate any reform of the tax legislative process was the proposal by President Kennedy in 1962 of a limited discretionary authority for the President to reduce (but not raise) individual income taxes, subject to Congressional veto. The idea was first broached by the President in his State of the Union and Budget Messages, and was outlined more fully in the Economic Report, all in January of 1962.[30] The President did not expect to need to exercise such discretionary authority in the near future, but, as he put it, "the time to repair the roof is when the sun is shining. . . ."[31] Nor did he expect the proposal to pass the Congress on the first attempt; rather it was an idea which the public and the Congress should begin to think about.[32] But "in the long run," he

30. State of the Union Message, Jan. 11, 1962, in Kennedy Papers 1962, *supra* note 25, Item [7] 5, 6 (1963); Budget Message, Jan. 18, 1962, *id.*, Item [13] 25, 35; Message to Congress Presenting the Economic Report, *id.*, Item [16] 42, 52.
31. State of the Union Message, Jan. 11, 1962, in *id.*, Item [7] 5, 6.
32. N.Y. Times, Jan. 12, 1962, at 1, col. 7.

felt, "we have a good chance to have it accepted."[33]

The Administration decided to embody the recommendation in a draft bill. On May 8, 1962, the President submitted to the Speaker of the House and the President of the Senate the draft of "A Bill To Amend the Internal Revenue Code of 1954 to provide standby authority for temporary reduction in the individual income tax when needed to meet the objectives of the Employment Act of 1946." The Speaker of the House and the President of the Senate dutifully transferred the draft bill to the House Ways and Means and Senate Finance Committees respectively,[34] and the bill was never seen again. There is no indication that it was ever discussed in either of those two "tax committees;" no hearings were held and no bill was ever reported out and debated.[35]

The gist of the proposal was stated in the 1962 Economic Report:

> "(1) Before proposing a temporary tax reduction, the President must make a finding that such action is required to meet the objectives of the Employment Act.[36]
>
> "(2) Upon such finding, the President would submit to Congress a proposed temporary uniform reduction in all individual income tax rates. The proposed temporary rates may not be more than 5 percentage points lower than the rates permanently established by the Congress.
>
> "(3) This change would take effect 30 days after submission, unless rejected by a joint resolution of the Congress.
>
> "(4) It would remain in effect for 6 months, subject to revision or renewal by the same process or extension by a joint resolution of the Congress.
>
> "(5) If the Congress were not in session, a Presidentially proposed tax adjustment would automatically take effect but would terminate 30 days after the Congress reconvened. Ex-

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33. News Conference, Jan. 31, 1962, in KENNEDY PAPERS 1962, *supra* note 25, Item [27] 90, 98.

34. 108 CONG. REC. 7892, 7894 (1962).

35. Nor was the draft bill ever published in any of the House or Senate Documents in any of the collections of Harvard University, a full depository library. However, a copy of the draft bill was obtained by the author from the Ways and Means Committee and is printed as an Appendix to this Note.

36. The Employment Act of 1946, 15 U.S.C. §§ 1021-25 (1964), declared that "it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy . . . to promote maximum employment, production, and purchasing power."

> tension would require a new proposal by the President, which would be subject to congressional veto."[37]

The idea of presidential discretionary authority[38] to alter income tax was not new in 1962. In May 1960, Representative Wright Patman had submitted "A Bill To Provide for increases and decreases in income tax if the President determines and proclaims that economic conditions require such increases or decreases."[39] The idea was suggested to President-elect Kennedy early in January 1961 in the report of a Task Force headed by economist Paul A. Samuelson.[40] But the most authoritative recent statement of the proposal could be found in the June 1961 report of the Commission on Money and Credit, a study group of bankers, businessmen, and economists.[41]

President Kennedy's proposal received widespread endorsement, not only from the *New York Times*[42] and organized labor,[43] but also from distinguished Republicans. Three former members of President Eisenhower's Council of Economic Advisers supported the principle

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37. ECONOMIC REPORT OF THE PRESIDENT 1962, at 18. According to the draft bill, these reforms were to be effected by amending the INTERNAL REVENUE CODE OF 1954, Part I, Subchapter A, Chapter I (on the determination of the tax liability of individuals). The bill would redesignate § 5 of the Code as § 6, and would add a new § 5 on "Temporary Tax Adjustments." A new subsection (k) would also be added to § 3402 of Chapter 24, to provide for "Temporary Withholding Tax Adjustments." [The present subsections (k), (l), and (m) of § 3402 had not yet been added in 1962.] (See Appendix.)

38. This terminology will be used in referring to the 1962 proposal; the "standby" language is better reserved for the expedited congressional enactment procedure described at pp. 284-87 *infra*.

39. The Patman bill would have added to Subchapter A of Chapter I of the INTERNAL REVENUE CODE OF 1954 a new Part V and § 51, authorizing the President to increase tax liabilities by as much as 10% to decrease the national debt in times of prosperity and to reduce tax liabilities by as much as 10% to prevent recessions. H.R. 12360, 86th Cong., 2d Sess. (1960), *reprinted in Hearings on the January 1961 Economic Report of the President and the Economic Situation and Outlook Before the Joint Economic Committee*, 87th Cong., 1st Sess. 225-26 (1961) [hereinafter cited as *Report Hearings 1961*].

40. *Samuelson Task Force Report for President-Elect Kennedy on the U.S. Economy*, Jan. 6, 1961, *reprinted in Report Hearings 1961*, *supra* note 39, at 703-11.

41. COMMISSION ON MONEY AND CREDIT, MONEY AND CREDIT: THEIR INFLUENCE ON JOBS, PRICES, AND GROWTH 131 (1961). The Commission recommended a presidential discretionary power to move first-bracket income tax rates upward or downward by as much as five percentage points. Administration officials in 1962 were quick to point to the Commission's report as "a stamp of conservative respectability" on the idea. N.Y. Times, Jan. 15, 1962 at 35, col. 1. But the Administration limited its own proposal to tax reduction. *See* note 59 *infra*.

42. Editorials, N.Y. Times, Jan. 12, 1962, at 34, col. 1; June 11, 1962, at 30, cols. 1, 5.

43. N.Y. Times, Feb. 25, 1962, at 44, col. 1.

of presidential discretionary authority.[44] David Rockefeller, President of the Chase Manhattan Bank, was reported to favor presidential discretionary power over corporate tax and investment credit, within specific ranges set by Congress.[45]

In Congress, the 1962 proposal received the support of the Joint Economic Committee.[46] This body, formerly known as the Joint Committee on the Economic Report, is the creation of the 1946 Employment Act.[47] Its members are drawn from ranking members of the related committees (such as Ways and Means, Finance, Banking and Currency) who request assignment. The committee has no legislative authority to introduce bills, but it exerts some influence over economic policy by holding hearings, making studies, and publishing reports on economic issues.

The proposal for presidential discretion has parallels abroad. In the United Kingdom, the Finance Act, 1961, granted to the Treasury a power to adjust customs and excise duties, purchase tax, and employers' contributions to National Insurance, by as much as ten per cent upward or downward, "if it appears . . . expedient, with a view to regulating the balance between demand and resources."[48] This power is exercised by Statutory Instrument, an executive order in the name of the Crown or of a Cabinet Minister, which must be approved by affirmative resolution in each House but may not be amended.[49] The income tax was not included in the "regulator," partly because of anticipated administrative difficulties (which may have been exaggerated), and partly because of fears that this would detract too

44. Arthur F. Burns, former Chairman of the CEA, speech to annual meeting of the American Statistical Association, Minneapolis, Sept. 7, 1962, in N.Y. Times, Sept. 8, 1962, at 20, col. 2; Paul W. McCracken, speech to the Symposium on Federal Taxation of the American Bankers Association, Washington, D.C., March 26, 1962, in N.Y. Times, March 27, 1962, at 28, col. 3; Henry C. Wallich, testimony in *Hearings on the January 1962 Economic Report of the President Before the Joint Economic Committee*, 87th Cong., 2d Sess. 621 (1962) [hereinafter cited as *Report Hearings 1962*].

45. N.Y. Times, Sept. 21, 1964, at 47, col. 6.

46. JOINT ECONOMIC COMMITTEE, 87TH CONG., 2D SESS., REPORT ON THE JANUARY 1962 ECONOMIC REPORT OF THE PRESIDENT 39-41 (Joint Comm. Print 1962).

47. 15 U.S.C. §§ 1021, 1024 (1964).

48. Finance Act of 1961, 9 & 10 Eliz. 2, c. 36, §§ 9, 30. On the "regulators" see S. BRITTAN, THE TREASURY UNDER THE TORIES 1951-1964, at 224-29 (1964).

49. The power was exercised by the Treasury in regard to excises and purchase tax in the Surcharge on Revenue Duties Order, [1961] 2 STAT. INSTR. 2667 (No. 1388).

much from the authority of Parliament.[50] The indirect taxes included in the "regulator," however, account for a greater proportion of total revenue yield in Britain than do the corresponding taxes in the United States.[51]

West Germany recently enacted a "Law for the Promotion of Stability and Economic Growth,"[52] which authorizes the Government to initiate or remove, subject to the approval of the *Bundesrat*,[53] a 7.5 per cent investment credit, a suspension of depreciation allowances, or a one-year ten per cent increase or reduction of individual and corporate income taxes. For many years Sweden has had an investment reserve scheme which operates as a discretionary investment tax or credit.[54] In Canada, the Carter Commission recommended in 1966 a "standby authority" for the Governor in Council[55] to raise or lower personal income tax rates across the board by as much as fifteen per cent, under certain conditions defined in terms of the economic indicators.[56]

The power of the purse is a traditional legislative prerogative, even in countries governed by a Cabinet system (as are all of the above). Yet these economically advanced societies seem to have found it both desirable and feasible to delegate discretionary power to the executive, within certain limits, in order to ensure the efficacy of fiscal policy.

2. The Constitutionality of Presidential Discretion

President Kennedy's proposed discretionary tax-reduction authority

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50. S. BRITTAN, THE TREASURY UNDER THE TORIES 1951-1964, at 224-25 (1964); Foster, *Taxation Policy and Growth*, in ECONOMIC GROWTH IN BRITAIN 170 (P. Henderson, ed., 1966).

51. *See* Table C-4 in J. PECHMAN, FEDERAL TAX POLICY 278 (1966).

52. *Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft, vom 8. Juni 1967,* [1967] *Bundesgesetzblatt* I S.582. *See* TAX NEWS SERV. I-25 (1967).

53. The *Bundesrat* is not an upper house of Parliament but a permanent conference of representatives of state governments.

54. *Kungliga Förordning om investeringsfonder för konjunkturutjämning,* 27 May 1955 (*Svensk författningssamling* 1955: 256). *See* HARVARD UNIVERSITY LAW SCHOOL, INTERNATIONAL PROGRAM IN TAXATION, WORLD TAX SERIES: TAXATION IN SWEDEN § 6.62c (1959); Mildner & Scott, *An Innovation in Fiscal Policy: The Swedish Investment Reserve System,* 15 NAT'L TAX J. 280 (1962).

55. The Governor-General of Canada is the Queen's representative; his power would be exercised in the name of the Crown but effectively at the behest of the Canadian cabinet.

56. 2 ROYAL COMMISSION ON TAXATION, REPORT 325-27 (Can. 1966). *See* note 92 *infra.* The Carter Commission's proposal of comprehensive reform of the Canadian tax structure was rejected by the Canadian government in December 1967, but the door was left open for adoption of specific recommendations. Christian Science Monitor, Dec. 13, 1967, at 16, col. 3.

was "in fundamental violation of the Constitution," according to the Chairman of the Senate Committee on Finance, Senator Harry F. Byrd.[57] The Senator probably had in mind article I, section 8 ("The Congress shall have Power To lay and collect Taxes . . . .") and article I, section 1 ("All legislative Powers herein granted shall be vested in a Congress of the United States . . . .").

The President argued to the contrary that his proposal involved no delegation of the legislative power to tax:

> "It asks only for authorization for a temporary and emergency reduction of income tax rates by the President, subject to Congressional disapproval, in situations where prompt action, whether or not the Congress is in session, is essential. The form of the income tax reduction would be provided for in advance by Congress; it would not be determined by the President. By the term of the draft legislation the fixed statutory rates may be reduced by not more than 5 percentage points and the period of tax reduction would be limited to six months, unless extended by a new plan within the procedures prescribed in the bill."[58]

Three threads in the Administration's argument may be distinguished: (1) Because an Act of Congress would establish the policy and format of the discretionary tax changes, with strict limits on their extent and duration, and because Congress would retain an ultimate power of disapproval, Congress would be fulfilling, not delegating, its legislative function. (2) Since the President asked only for the power to reduce tax rates, and not for the power to raise them as well, this would be only an authority to "suspend" the "fixed" statutory rates rather than a delegated power to establish new ones.[59] (3) The President's authority would be of an "emergency" nature and circumscribed by the requirement that the President make a showing of emergency whenever he exercised it.

The policy against delegation of the legislative power has roots deep in constitutional history. One source of the rule is the maxim, *Dele-*

57. *Quoted in* N.Y. Times, Jan. 12, 1962, at 14, col. 1.

58. Letter to the President of the Senate and the Speaker of the House Concerning Standby Authority to Reduce Income Taxes, May 8, 1962, in KENNEDY PAPERS 1962, *supra* note 25, Item [176] 371 (1963), and in S. JOUR. 87TH CONG., 2D SESS. 238-39 (1962).

59. According to Walter Heller, it was precisely for this reason that the proposal was limited to tax reduction. *Report Hearings 1962, supra* note 44, at 28. The expected opposition of Representative Wilbur Mills, chairman of the House Committee on Ways and Means, may have been a more compelling reason. N.Y. Times, Jan. 12, 1962, at 13, cols. 7-8.

*gata potestas non potest delegari.*[60] Although the origin and interpretation of the maxim are the subject of scholarly dispute, its message seems to be that a power entrusted by the people to their legislative representatives may not be entrusted by the legislature to anyone else.[61]

Locke first raised the idea to the status of a dogma against subdelegation of the legislative power.[62] In Locke, the principle is supported by a theory of the sovereignty of the legislature as the bearer of a sacred trust from the people. But in American constitutional theory, the doctrine of the separation of powers only confirms the maxim.[63]

So much for the theory. American constitutional practice has been more complicated. The closest analogue to the discretionary tax-reduction proposal is the authority often granted to the executive to modify existing tariff laws.[64] The same sentence in article I which confers the tariff power upon Congress also confers upon it the power to tax ("The Congress shall have power to lay and collect Taxes, Duties, Imposts, and Excises . . . .").[65] The tariff power and the taxing power thus appear to stand on an equal basis, and Congress should have as much right to delegate the one as to delegate the other.

Arguably the delegated tariff authority is distinguishable because it overlaps the recognized presidential power to conduct foreign relations.[66] Thus the Trade Expansion Act of 1962[67] granted discretionary powers to the President for the purpose of negotiating tariff

60. "A delegated power cannot be (further) delegated."

61. *Compare* Duff & Whiteside, *Delegata Potestas Non Potest Delegari,* 14 CORNELL L.Q. 168 (1929) *with* Ehmke, *"Delegata Potestas Non Potest Delegari:" A Maxim of American Constitutional Law,* 47 CORNELL L.Q. 50 (1961). The maxim has long been treated as a rule of agency, to the effect that an agent may not entrust to another any tasks entrusted personally to him. J. STORY, COMMENTARIES ON THE LAW OF AGENCY § 13 (1839). *Cf.* J. W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 405 (1928); Locke's Appeal, 72 Pa. 491, 496 (1873). But its constitutional application is even more ancient. It appears in Bracton in a discussion of monarchical jurisdiction. DE LEGIBUS ET CONSUETUDINIBUS ANGLIAE, f. 55b.

62. J. LOCKE, OF CIVIL GOVERNMENT §§ 141-42 (1691).

63. J. W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 406 (1928).

64. Walter Heller cited this as the nearest precedent to the authority sought in 1962 by President Kennedy. *Report Hearings 1962, supra* note 44, at 69. For a list of tariff acts granting powers to the President see Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294, 308 (1933).

65. U.S. CONST., art. I, § 8.

66. On the presidential power over foreign relations see, *e.g.,* United States v. Curtiss-Wright Export Corp., 299 U.S. 304 (1936); Zemel v. Rusk, 381 U.S. 1, 17 (1965).

67. 19 U.S.C. §§ 1801, 1821 (1964).

agreements with foreign governments. On the other hand, the Supreme Court has upheld previous tariff acts which granted discretionary powers for purposes other than international negotiation.[68]

The Tariff Act of 1890, section 3, for example, authorized the President to "suspend" the free importation of certain goods "for such time as he shall deem just," whenever he is "satisfied" that the exporting nation imposes tariffs which he may "deem" to be "reciprocally unequal or unreasonable."[69] The constitutionality of this authorization was upheld in *Field v. Clark.*[70] The Court affirmed that the principle against delegation was "universally recognized as vital" to our system of government, but that section 3 of the Tariff Act involved no such delegation:

> "Legislative power was exercised when Congress declared the suspension should take effect upon a stated contingency."[71]

The Court quoted from an Ohio opinion:

> "The true distinction is between the delegation of power to make the law, which necessarily involves a discretion as to what it shall be, and conferring authority or discretion as to its execution, to be exercised under and in pursuance of the law. The first cannot be done; to the latter no valid objection can be made."[72]

The conclusory usage of the term "delegation" in *Field v. Clark,* and the language of "suspension" in the 1890 Tariff Act, may explain the first two threads in the argument of the Kennedy Administration in 1962.[73]

But no neat "suspension-of-fixed-rates" interpretation could be applied to the "flexible tariff" provision of the 1922 Tariff Act, which was upheld by the Court in *J. W. Hampton, Jr. & Co. v. United States.*[74] The Tariff Act of 1922, Title III, section 315(a), empowered and directed the President to increase or decrease certain duties so as to equalize the difference which he found between the costs of producing certain goods at home and abroad.[75] The Act laid

68. Field v. Clark, 143 U.S. 649 (1892); J. W. Hampton, Jr. & Co. v. United States, 276 U.S. 394 (1928).
69. 26 Stat. 567, 612.
70. 143 U.S. 649 (1892).
71. *Id.*, at 692, 693.
72. Cincinnati, W.&Z.R.R. v. Comm'rs, 1 Ohio St. 77, 88-89 (1852), *quoted in* 143 U.S. at 693-94.
73. *See* p. 276 *supra.*
74. 276 U.S. 394 (1928).
75. 42 Stat. 858, 941.

down criteria to be considered in ascertaining the differences; it fixed certain limits on presidential tariff changes and required an investigation by the Tariff Commission[76] as a preliminary to any presidential proclamation changing the duties. Chief Justice Taft, for the court, said:

> "Congress may feel itself unable conveniently to determine exactly when its exercise of the legislative power should become effective, because dependent on future conditions, and it may leave the determination of such time to the decision of an Executive. . . ."[77]

This justified a carefully circumscribed presidential discretionary authority to vary tariffs upward or downward. *Hampton*, then, seems to make it unnecessary to limit the President to mere "suspension" of rates.

Thus in practice Congress may indeed delegate powers to other branches of Government, even if these legislative powers are "softened by a *quasi*."[78] In general these grants of power can be justified on either of two grounds. Congress may grant an authority to "fill up the details" of a statute, even where the power involved is such as the legislature could properly exercise itself.[79] The details to "fill up" are supposed to be merely "minor regulations."[80] Alternatively, Congress may legislate contingently, assigning to others the task of ascertaining the presence of facts which bring its declared policy into operation.[81] Thus Congress could command that a previously enacted statute be revived, suspended, or modified,[82] or that a specified new rule be put into operation upon the finding of certain facts by an ex-

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76. The Court pointed out that the presence of an advisory commission was not essential. 276 U.S. at 409-10, *citing* Field v. Clark, 143 U.S. 649 (1892).

77. 276 U.S. at 407.

78. The phrase comes from Holmes, J., dissenting in Springer v. Gov't of the Philippines, 277 U.S. 189, 210 (1928).

79. Wayman v. Southard, 23 U.S. (10 Wheat.) 1, 43 (1825) (delegating to the Judiciary an authority to establish uniform forms of writs and modes of process for federal courts); United States v. Grimaud, 220 U.S. 506 (1911) (delegating to the Secretary of Agriculture an authority to make regulations for U.S. forest reserves).

80. Wayman v. Southard, 23 U.S. (10 Wheat.) 1, 45 (1825); *See* Sunshine Anthracite Coal Co. v. Adkins, 310 U.S. 381, 398 (1939).

81. Opp Cotton Mills, Inc. v. Adm'r, 312 U.S. 126 (1941); United States v. Rock Royal Co-operative Inc., 307 U.S. 533 (1939); Martin v. Mott, 25 U.S. (12 Wheat.) 19 (1827); The Brig Aurora, 11 U.S. (7 Cranch) 382 (1813).

82. The Brig Aurora, 11 U.S. (7 Cranch) 382 (1813); E. CORWIN, N. SMALL, & L. JAYSON, THE CONSTITUTION OF THE UNITED STATES OF AMERICA: ANALYSIS AND INTERPRETATION, S. DOC. No. 39, 88th Cong., 1st Sess. 101 (1964).

ecutive or administrative officer.[83] As long ago as 1813, for example, in *The Brig Aurora,* the Court upheld an act of Congress which made the revival of a lapsed non-intercourse statute dependent upon the President's finding and proclamation that either Great Britain or France (but not both) had "cease[d] to violate the neutral commerce of the United States."[84]

The presidential power over tariffs would seem to be a blend of these two grounds. Such authority involves "details" to "fill up," as well as a stated contingency upon which the authority may be exercised. The Court in *Hampton* was willing to treat tariff rates as "details"[85] for the executive to deal with, in the context of a congressional policy of equalizing domestic and foreign costs. The "contingency" feature was given prominence in *Field v. Clark,*[86] but it was an element in *Hampton* as well.[87] The same reasoning could apply equally to a grant of authority to the President to alter tax rates. Congress might well conclude both (a) that the economic decisions underlying countercyclical tax policy are better made by administrative organs with more technical expertise and detailed information, and (b) that the most efficient technique of tax policy is to permit the President to make tax changes to meet such economic contingencies as Congress can specify in advance.

One essential constitutional rule is that the enabling statute must declare a congressional policy and set forth an "intelligible principle" to which executive action must conform.[88] In other words, Congress must first exercise its essential legislative (in the sense of policy-making) function.[89] Requiring the President to make a reasoned finding is a way of limiting his exercise of authority to situations contemplated in the enabling act. This was the third thread in the Administration's argument for the constitutionality of the 1962 tax-reduction proposal.[90]

The triggering contingency specified in the 1962 tax-reduction pro-

83. Opp Cotton Mills, Inc. v. Adm'r, 312 U.S. 126 (1941); United States v. Rock Royal Co-operative Inc., 307 U.S. 533 (1939).
84. 11 U.S. (7 Cranch) 382 (1813).
85. 276 U.S. at 406.
86. 143 U.S. at 693. *See* p. 278 *supra.*
87. 276 U.S. at 407. *See* p. 279 *supra.*
88. J. W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 409 (1928); Star-Kist Foods, Inc. v. United States, 275 F.2d 472, 47 C.C.P.A. 52 (1959).
89. Opp Cotton Mills, Inc. v. Adm'r, 312 U.S. 126, 144, 145 (1941) (minimum wage); *accord,* Yakus v. United States, 321 U.S. 414, 424 (1944) (Emergency Price Control Act).
90. *See* p. 276 *supra.*

posal was defined simply in terms of the 1946 Employment Act. The President was to prepare and submit a plan of tax reduction when he determined that such a measure was "required to meet the objectives of the Employment Act of 1946," which were "maximum employment, production, and purchasing power."[91] This definition of the contingency was less precise than that in the 1966 Canadian tax proposal, which would have limited the discretionary authority to certain conditions defined in terms of the economic indicators.[92] The same device of the economic indicators was used by President Kennedy in 1962 to define the limits of a proposed "standby capital improvements authority," which would have permitted him to increase expenditure on public works for fiscal purposes.[93] But his failure to use this device in his tax proposal was probably due to the weaknesses of the formulistic approach to short-run tax measures.[94] Genuine discretion is the desideratum; even the Canadian proposal had an opening for other "emergency" reasons not covered by the formula.[95]

In any event, if presidential discretion is the most effective way to carry out a proper countercyclical tax policy, the absence of a formula is not an argument against the constitutionality of such a proposal. Once Congress has adopted a policy, it may grant discretionary authority to the executive if its policy could not otherwise be carried out.[96] If Congress decides that speed is of the essence in tax policy, and that it does not itself possess the information or the decision-making capacity for rapid tax changes, then to prohibit a grant to the executive would frustrate Congress's exercise of its own law-making

91. Draft bill, § 3 (See Appendix).

92. The Governor in Council would have authority to raise or lower individual income taxes by as much as 15% across the board, but only if (*a*) the seasonally adjusted unemployment rate has averaged 4.5% or more over the preceding 3 months, (*b*) the seasonally adjusted price indices have risen at an annual average rate of 3% for the preceding 6 months, or (*c*) the Minister of Finance reports to Parliament on "reasons of national emergency other than those related to prices and employment." 2 ROYAL COMMISSION ON TAXATION, REPORT 326 (Can. 1966).

93. President Kennedy requested a discretionary authority "to accelerate and initiate up to $2 billion of appropriately timed capital improvements" within 2 months after the seasonally adjusted unemployment rate (*a*) had risen in at least three out of four months (or four out of six months) and (*b*) had risen to a level at least one percentage point higher than its level four months (or six months) earlier. ECONOMIC REPORT OF THE PRESIDENT 1962, at 19.

94. *See* pp. 287-89 *infra*.

95. *See* note 92 *supra*.

96. Buttfield v. Stranahan, 192 U.S. 470, 496 (1903) (Treasury authority to inspect tea imports); *see* Opp. Cotton Mills, Inc. v. Adm'r, 312 U.S. 126, 145 (1941); J. W. Hampton, Jr. & Co. v. United States, 276 U.S. 394, 407 (1928); Field v. Clark, 143 U.S. 649, 691 (1892); Locke's Appeal, 72 Pa. 491, 498 (1873).

power. Delegation to the President, whether or not "softened by a *quasi*," would seem warranted by the necessary-and-proper clause.[97]

The Supreme Court has held grants of power to the executive unconstitutional only when none of the above criteria were met.[98] In *Panama Refining Co. v. Ryan*,[99] section 9(c) of the National Industrial Recovery Act of 1933 authorized the President to prohibit the transportation in interstate and foreign commerce of petroleum products produced or withdrawn from storage in excess of the amount permitted by state law.[100] The section was held unconstitutional because it stated no criteria for the exercise of the power, and required no presidential finding.[101] Nor was there a "definition of circumstances and conditions in which the transportation is to be allowed or prohibited."[102] In *A.L.A. Schechter Poultry Co. v. United States*,[103] the Court held unconsitutional section 3 of the N.I.R.A., which authorized the President to approve "codes of fair competition," on such terms as he "in his discretion deems necessary" to effectuate the title's general policy of economic recovery. The Court found the "fair competition" standard too indefinite, the required presidential findings too conclusory, and the congressionally-established ground rules nonexistent.[104]

The Kennedy proposal's standards were more definite than those in *Panama Refining* and *Schechter Poultry*. The Employment Act test mentions three measurable economic criteria — employment, production, and purchasing power — and the President is to declare a finding in these terms. (A draftsman could easily add "wage and price stability" if a power to increase tax rates is included.) The draft

97. Cheadle, *The Delegation of Legislative Functions*, 27 YALE L.J. 892, 900 (1918).

98. *Compare* Panama Refining Co. v. Ryan, 293 U.S. 388 (1935) *and* A. L. A. Schechter Poultry Co. v. United States, 295 U.S. 495 (1935) *with* Opp Cotton Mills, Inc. v. Adm'r, 312 U.S. 126 (1941) *and* United States v. Rock Royal Co-operative, Inc., 307 U.S. 533 (1939); *see* Weeks, *Legislative Power versus Delegated Legislative Power*, 25 GEO. L.J. 314, 334 (1937).

99. 293 U.S. 388 (1935).

100. 48 Stat. 195, 200.

101. 293 U.S. at 415.

102. *Id.*, at 430. Justice Cardozo, in dissent, had to argue that the congressional standards expressed in other provisions of the Act were implied in section 9. *Id.*, at 439.

103. 295 U.S. 495 (1935).

104. Justice Cardozo concurred, stating: "Here . . . is an attempted delegation not confined to any single act nor to any class or group of acts identified or described by reference to a standard. Here in effect is a roving commission to inquire into evils and upon discovery correct them." *Id.*, at 551.

bill's declaration of policy makes clear Congress's desire "to adopt a procedure to provide for the effectuation of such [tax] reduction more speedily than by means of the enactment of specific legislation."[105] It is impossible to divorce the grant of authority from the purpose of the bill.

One additional constitutional provision should be considered briefly. The first paragraph of article I, section 7, provides: "All Bills for Raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills." Arguably this implies that revenue bills as such must be worked out in detail by Congress itself.[106] On the other hand, the provision on its face is not directed at the distribution of power between Congress and the executive; rather it distributes functions between the House and Senate. The section deals generally with the parliamentary procedure of passing bills: The provision in question distinguishes revenue bills from the run of bills, which may originate in either House. It does not purport to make revenue bills unique in any other sense.

Finally, we come to what may be the strongest argument for the constitutionality of President Kennedy's proposal — the provision for specific congressional veto by joint resolution. The preceding analysis suggests that presidential discretion would be constitutionally acceptable even without such a provision. But the inclusion of a congressional veto would serve a constitutional as well as a political function by emphasizing that the reform does not deprive Congress of its lawmaking power. For Congress itself would be the policeman empowered to ensure that the President does not deviate from the standards laid down in the enabling act. If the standards seem not definite enough, Congress itself would construe the enabling statute and determine in every case whether the specific tax change proposed by the President is authorized. It may indeed turn out that the enabling statute confers too little discretionary authority on the President, not too much. Congress's reluctance to grant so carefully limited a discretionary authority to the President appears therefore to be the result of its own choice or custom, not of constitutional requirement.

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105. Draft bill, § 2 (See Appendix).

106. This suggestion occurs in a general discussion of delegation in Cheadle, *The Delegation of Legislative Functions*, 27 YALE L.J. 892, 900-01 (1918).

### B. *Congressional Standby Legislation*

Congressional standby legislation represents a second approach to reform of the tax legislative process. In essence, it involves a reform of congressional procedure rather than delegation of authority to the executive. The Administration gradually shifted to this new approach and made no serious attempt to rescue President Kennedy's 1962 proposal from the Memory Hole of Ways and Means. In his January 1963 Economic Report, President Kennedy merely urged that "work on the development of an acceptable plan for quick tax action to counter future recessions should continue."[107] In 1965, President Johnson suggested:

> "The Congress could reinforce confidence that jobs and markets will be sustained by insuring that its procedures will permit rapid action on temporary income tax cuts if recession threatens."[108]

As Treasury Secretary Dillon explained to the Senate Committee on Finance, this meant:

> "a system whereby the Congress, by previous study, had an understanding that a request by the President on an emergency basis would be handled in emergency fashion . . . in a rapid period of time through the normal processes of committee work and so forth, and acted on and voted up or down by the Congress."[109]

By 1966, after the Congress's swift passage of the Excise Tax Reduction Act of the previous year, President Johnson was content to recommend:

> "background tax studies by both the Congress and the Executive Branch . . . to permit quick decisions and prompt action to accommodate shortrun cyclical changes. If quick action is ever needed, we should not have to begin a long debate on what the changes in taxes should be."[110]

The Johnson Administration made no detailed recommendations. Not only was the 1962 proposal of discretionary authority abandoned,[111] but no effort was made to press the congressional-standby

107. ECONOMIC REPORT OF THE PRESIDENT 1963, at xxi.

108. ECONOMIC REPORT OF THE PRESIDENT 1965, at 11.

109. *Hearings on H.R. 11375 (Debt Limit) Before the Senate Committee on Finance*, 88th Cong., 2d Sess. 11 (1964). *Cf.* Speech to 34th National Business Conference of the Harvard Business School, June 1, 1964, *quoted in* N.Y. Times, June 7, 1964, at 46, col. 4.

110. ECONOMIC REPORT OF THE PRESIDENT 1966, at 18.

111. *Hearings on the January 1966 Economic Report of the President Before the Joint Economic Committee*, 89th Cong., 2d Sess., pt. 1, at 19-20 (1966) (Gardner Ackley).

idea either.[112] Similar proposals for congressional standby legislation, however, have been made by a subcommittee of the Joint Economic Committee[113] and by economists such as Harvey E. Brazer and Robert A. Gordon.[114]

The gist of these proposals is that Congress can legislate in advance the ground rules for short-run tax changes and then enact specific tax measures. quickly whenever needed. The enabling act, perhaps by way of amending the Employment Act of 1946, would establish an expedited procedure and decide a number of policy and technical questions in advance. For example, Congress, in passing the enabling act, could decide (*a*) that the income tax is the most important instrument of tax policy; (*b*) that the investment credit is not suited for short-run stabilization policy; (*c*) that personal and corporate income tax rates should be altered together for equity's sake rather than personal rates alone; (*d*) that the rates should be changed across the board, rather than in the first bracket alone; (*e*) that the change should be by a uniform percentage of total taxable income rather than by a uniform percentage of tax;[115] (*f*) that a short-run tax measure should expire in three months in order to give Congress an opportunity to drop it, extend it, or adjust it; (*g*) that the short-cut procedure should not be used where a change of ten per cent of the rates or more is contemplated; (*h*) that the Council of Economic Advisers should issue a quarterly economic report, to keep Congress abreast of short-run economic conditions; and (*i*) that the Senate and House hearings on the joint resolution to "trigger" a specific tax change should be held jointly.

Whenever a specific short-run tax change is deemed necessary by the President or by congressional leaders, hearings and debates could then be held on the triggering resolution. These could focus on such questions as what precise amount of tax change is needed, indeed

112. *See id.*, at 161-62 (statement of the Bureau of the Budget); N.Y. Times, March 21, 1966, at 1, col. 5.

113. SUBCOMMITTEE ON FISCAL POLICY, JOINT ECONOMIC COMMITTEE, 89TH CONG., 2D SESS., REPORT ON TAX CHANGES FOR SHORTRUN STABILIZATION 16 (Joint Comm. Print 1966) [hereinafter cited as TAX CHANGES REPORT]; JOINT ECONOMIC COMMITTEE, 89TH CONG., 2D SESS., REPORT ON THE JANUARY 1966 ECONOMIC REPORT OF THE PRESIDENT 5 (Joint Comm. Print 1966).

114. *Hearings on Tax Changes for Shortrun Stabilization Before the Subcommittee on Fiscal Policy of the Joint Economic Committee* 89th Cong., 2d Sess. 6-7 (1966) (Brazer), 58 (Gordon) [hereinafter cited as *Tax Changes Hearings*].

115. That is, everyone's tax *rate* would go up or down by *X* points, rather than that everyone's tax *payment* would be increased or decreased by *Y* per cent. The latter is the method of the "surcharge."

whether there should be one at all, or even what price should be exacted from the executive in return for congressional approval of a presidential proposal. The will of Congress could not be frustrated, but both it and the executive would be under pressure to decide quickly, say within 30 or 60 days.

This "congressional standby" proposal appeals to some who would accept reform but dislike the idea of presidential discretion.[116] It is acceptable as a compromise to others who would prefer presidential discretion.[117] As such it may be the reform proposal most likely to succeed.

The Ways and Means Committee, however, doubts that the congressional standby scheme would work. Its reasoning is reportedly as follows: The standby procedure involves an "unnecessary duplication of effort and a waste of time." The Committee will have to handle the same tax matter twice, first as an enabling act establishing the standby procedure, and again as a "triggering" resolution enacting a specific tax change. Furthermore, both the enabling bill and the triggering resolution would be subject to amendment in the Senate, raising the possibility of time-consuming negotiations in the Senate-House Conference. The enabling legislation could be rewritten by an amendment to a triggering resolution, and the advance planning would go for nought. In any case, the Committee believes, it is difficult if not impossible to determine well in advance the size or type of tax measure that future economic contingencies may require.[118]

The answer to this pessimistic attitude is that the passage of the enabling act would represent a political commitment to a new policy and procedure. Congress can never bind itself irrevocably in any legislation, but once it has reached consensus and enacted a reform it is unlikely to call the new policy and procedure into question when considering a triggering resolution. The standby proposal does not purport to bypass the legislative process or to force Congress to accept tax changes which it does not approve. But it will be politically difficult for Congress to turn its back on the improved procedure at a later date. Since, moreover, it is feasible to devise a standard type of tax

116. *See, e.g.*, COMMITTEE FOR ECONOMIC DEVELOPMENT, FISCAL AND MONETARY POLICY FOR HIGH EMPLOYMENT 33-34 (1962).

117. *See, e.g.*, JOINT ECONOMIC COMMITTEE, 87TH CONG., 2D SESS., REPORT ON THE JANUARY 1962 ECONOMIC REPORT OF THE PRESIDENT 39-41 (Joint Comm. Print 1962); *Report Hearings 1962*, *supra* note 44, at 621 (1962) (Henry C. Wallich); W. HELLER, NEW DIMENSIONS OF POLITICAL ECONOMY 101-02 (1967).

118. N.Y. Times, March 21, 1966, at 1, col. 7; at 20, col. 5.

measure appropriate for most economic contingencies,[119] the choice of tax format, once made, will expedite law-making and not constrain it.

The tribulations of the 1967 income tax surcharge proposal illustrate how an expedited congressional procedure could enhance the deftness of tax policy. The surcharge proposal, when first made in January, 1967,[120] anticipated an inflationary trend that had not yet developed but was expected to emerge later in the year.[121] The Administration planned to reassess the surcharge proposal in the light of economic conditions in April or May.[122] No tax message was submitted to Congress until August 3, 1967.[123] Even then, inflation was still only a "possibility," and the surcharge was to be "insurance against the risk."[124] Thus the delay from January to August was due to both hesitancy and anticipation on the part of the Administration. It had to submit a tax proposal early enough to allow for congressional delay, but this meant making a recommendation before either it or Congress was persuaded of immediate need. It would be an advantage of the standby procedure that such anticipatory proposals would not be necessary. The Administration could afford to wait until its statistical evidence was more concrete and more persuasive, knowing that Congress could respond quickly once the proposal was submitted.

### C. *Formula Flexibility*

The third proposed mechanism for rapid tax changes would alter the level of income tax rates automatically whenever certain economic indicators changed by stipulated amounts. Once the scheme is in force, an agreed-upon tax reduction or increase would go into effect, without any decision by Congress or the President, if (*a*) unemployment rose to a specified level or rate, (*b*) the Consumer Price Index rose a specified amount within a certain period of time, or (*c*) the

119. *See* Section IV *infra.*

120. ECONOMIC REPORT OF THE PRESIDENT 1967, at 9.

121. *Hearings on the January 1967 Economic Report of the President Before the Joint Economic Committee,* 90th Cong., 1st Sess., pt. 1, at 149 (1967) (Henry Fowler, Feb. 6, 1967).

122. *Id.*, at 216.

123. President's Message on the State of the Budget and the Economy, August 3, 1967, in 3 WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS 1084 (No. 31, Aug. 7, 1967).

124. *Hearings on the President's 1967 Tax Proposals Before the House Committee on Ways and Means,* 90th Cong., 1st Sess., pt. 1, at 16, 24 (Henry Fowler, Aug. 14, 1967).

index of industrial production rose at too rapid a rate. This mechanism has been endorsed by the Commission on Money and Credit[125] and by economists such as Professor Alvin H. Hansen.[126] The Commission saw it as a device for strengthening the automatic stabilizers. Indeed it would be comparable to one of the stabilizers currently in force: Governmental transfer payments, *e.g.*, unemployment compensation and Social Security, are paid out routinely to eligible applicants. When incomes are falling, more is paid out; and when incomes and employment rise, less is paid out — without any specific short-run legislation.[127]

A variation of the proposal, on the other hand, has been urged as a way of preventing the automatic stabilizers from retarding economic growth.[128] In addition, Senator Barry Goldwater has offered a related suggestion, as a way of permanently but gradually reducing federal income taxes. In September 1964, the Senator proposed a 25 per cent reduction in tax rates over a five-year period, on the theory that, if federal expenditure were stabilized, a steadily growing GNP would generate an excess of revenue over expenditure; this excess could be returned to the taxpayers.[129]

The basic idea of formula flexibility appeals to some who disapprove of presidential discretionary authority,[130] to others who would prefer presidential discretion but suspect that Congress would never delegate such authority,[131] and to still others who would accept presidential authority but regard the formula device as more efficient. Professor Hansen, one of the third group, sees the device as a way of insulating both the President and the Congress from political pressures.[132]

But formula flexibility has several disadvantages from the stand-

125. COMMISSION ON MONEY AND CREDIT, MONEY AND CREDIT: THEIR INFLUENCE ON JOBS, PRICES AND GROWTH 129 (1961).

126. *Report Hearings 1962, supra* note 44, at 615. *See also* JOINT COMMITTEE ON THE ECONOMIC REPORT, 84TH CONG., 2D SESS., PAPERS ON FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY 62-66 (Joint Comm. Print 1956) (E. Hagen); *Hearing on Federal Expenditure and Revenue Policies Before the Joint Committee on the Economic Report,* 81st Cong., 1st Sess. 8-9 (1949) (National Planning Association).

127. *See* D. OTT & A. OTT, FEDERAL BUDGET POLICY 73 (1965).

128. Weckstein, *Fiscal Reform and Economic Growth,* 17 NAT'L TAX J. 325, 326 (1964); *Tax Changes Hearings, supra* note 114, at 56 (Robert A. Gordon).

129. N.Y. Times, Sept. 8, 1964, at 1, col. 6.

130. *E.g.,* M. FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS 133-56 (1953). Professor Friedman was reportedly the inspiration behind Senator Goldwater's proposal. N.Y. Times, Sept. 21, 1964, at 47, col. 6.

131. *E.g., Tax Changes Hearings, supra* note 114, at 56-58 (Robert A. Gordon).

132. *Report Hearings 1962, supra* note 44, at 647.

point of economics. First, the economic indicators are not sufficiently developed to rule out erratic or misleading signals.[133] One economist has pointed out:

> "The automatic imposition of a tax increase following a one-shot increase in the Consumers [*sic*] Price Index, which in turn was caused by some autonomous force, may serve only to depress the level of economic activity. Even when the automatic increase in taxes is justified, what shall be the criteria for its removal? A 6-month period of price stability? It may be that the additional tax is just sufficient to restrain inflation and its automatic removal would be harmful."[134]

The inflexibility of the formula is the principal argument against it.[135]

Secondly, economic objectives may conflict in the short run. Unemployment, inflation, and a balance of payments deficit could occur in the same period. How do we program the formula for this contingency?[136] Some discretion as to the amount and timing, or indeed the suitability, of a tax measure would be called for. Thirdly, the Administration would be tempted to intervene if the formula's operation is clearly faulty or if unusual circumstances arise. If so, then the advantage of the prearranged formula would disappear. Professor Hansen had to recommend a discretionary authority for the President "to veto such automatic adjustments if in his judgment and that of his advisers, special circumstances so warrant."[137]

## IV. The Economics of Prearrangement

The formula approach raises in acute form a question common to all these reform proposals: How feasible is it to select in advance a standard type of tax measure? For both the presidential-discretion and the congressional-standby proposals envisage prearrangement of method, though tempered by discretion and choice.

The central inquiry is, what are the relative advantages and disadvantages of different forms of taxation? We have seen that the British economic "regulator" relies on indirect taxes rather than on

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133. 2 Royal Commission on Taxation, Report 84 (Can. 1966). For a critical study of some of the indices see Subcommittee on Economic Statistics, Joint Economic Committee, 89th Cong., 2d Sess., Report on Government Price Statistics (Joint Comm. Print 1966).

134. Keiser, *supra* note 6, at 359.

135. Tax Changes Report, *supra* note 113, at 16; R. Musgrave, The Theory of Public Finance 515-17 (1959).

136. *Tax Changes Hearings, supra* note 114, at 76 (Henry C. Wallich).

137. *Report Hearings 1962, supra* note 44, at 615.

the income tax.[138] Excise taxes were altered partly for countercyclical reasons in the United States in 1965 and 1966.[139] Some favor the use of the excise tax for Keynesian purposes,[140] while others criticize it as being too difficult to administer.[141] Payroll taxes were also included in the British "regulator" (although this power has never been exercised),[142] but these are seen here as having undesirable side effects on Social Security financing, business costs, and the distribution of the tax burden.[143] Some economists have suggested an inventory tax for countercyclical purposes, since inventory investment is a highly destabilizing factor.[144] A tax on value added has also been suggested: This would replace many of the current variety of taxes and could easily be manipulated for quick and wide impact.[145]

The investment credit[146] and accelerated depreciation[147] provisions of 1962 were notable experiments of the recent period. The investment credit permitted firms to deduct as a credit against tax seven per cent of the amount of certain new investment with a service life of eight years or more (with partial credit for assets with service lives of between four and eight years). The impact of the passage of the investment credit was probably considerable.[148] In spite of assurances by the Kennedy Administration in 1962 that the credit was to be a permanent feature of the tax structure, the credit and depreciation provisions were suspended in November 1966 for anti-inflationary purposes, and restored in June 1967.[149] David Rockefeller was re-

138. *See* pp. 274-75 *supra.*

139. Excise Tax Reduction Act of 1965, 78 Stat. 136; Tax Adjustment Act of 1966, 80 Stat. 38.

140. *E.g.*, Johnson, *Excise Tax Reductions and Consumption Expenditure*, 43 TAXES 395 (1965).

141. *Tax Changes Hearings, supra* note 114, at 24 (C. Lowell Harriss), 244-45 (Stanley S. Surrey).

142. Finance Act of 1961, 9 & 10 Eliz. 2, c. 36, § 30 (U.K.). *See* S. BRITTAN, THE TREASURY UNDER THE TORIES 1951-1964, at 226-29 (1966).

143. *Tax Changes Hearings, supra* note 114, at 245 (Stanley S. Surrey). On payroll taxes in the U.S. see J. PECHMAN, FEDERAL TAX POLICY ch. 7 (1966).

144. *Tax Changes Hearings, supra* note 114, at 79-80 (Henry C. Wallich).

145. *Id.*, at 66-69 (Arnold Harberger).

146. Revenue Act of 1962, 79 Stat. 960.

147. This originated in a Treasury ruling, Rev. Proc. 62-21, 1962-2 CUM. BULL. 418.

148. Hall & Jorgenson, *Tax Policy and Investment Behavior*, 57 AM. ECON. REV. 391, 413 (1967); J. PECHMAN, FEDERAL TAX POLICY 121-23 (1966). *Contra*, Cook, *The Investment Credit: Investment Incentive and Countercyclical Tool*, 45 TAXES 227 (1967).

149. Investment Credit and Accelerated Depreciation Suspension Act of 1966, 80 Stat. 1508; Restoration of Investment Credit and Accelerated Depreciation Act of 1967, Pub. L. No. 90-26 (June 13, 1967).

ported in 1964 to favor the discretionary use of the investment credit (as well as the corporate income tax).[150] West Germany has developed the investment credit into a discretionary fiscal tool for use by the executive branch.[151]

The advantage of a variable investment credit is that without it there is no effective fiscal tool for restricting or stimulating investment demand alone.[152] Investment is a more volatile sector of the economy than consumption and has been a significant factor in postwar inflations.[153] The speed with which the investment credit was suspended and then restored would bode well for its future as a useful countercyclical weapon.[154]

On the other hand, the experience of the investment credit reveals certain political weaknesses that could prove to be its undoing. A tax measure that benefits only one segment of the community will create a vested interest for that group and antagonize other groups. Thus the suspension of the credit in 1966 aroused severe criticism from the business community, which had expected the credit to be permanent. Businessmen praised it as an essential stimulant to innovation and growth, and argued that its manipulation disrupted sound business planning.[155] Organized labor on the other hand, argued that the 1966 inflation was concentrated in the capital goods industry, and that suspension of the investment credit was therefore more appropriate than an across-the-board increase in income taxes.[156] The speed of passage of the Suspension Act was thus deceptive; special interests concentrated their efforts on getting special exceptions rather than on attacking the Act directly; many such efforts succeeded.[157] Restoration of the credit looked to some like a selective tax "break", which made it politically more difficult to impose an income-tax sur-

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150. N.Y. Times, Sept. 21, 1964, at 47, col. 6. *See* p. 274 *supra.*

151. *See* p. 275 and note 52 *supra.*

152. A tight monetary policy, the usual alternative, has not been very successful. KEISER, *supra* note 6, at 278.

153. *Id.*, at 277-78.

154. Suspension took two months, and restoration took three months. *See* Table I *supra.*

155. See the arguments collected in Cook, *The Investment Credit: Investment Incentive and Countercyclical Tool,* 45 TAXES 227 (1967).

156. *Tax Changes Hearings, supra* note 114, at 211-17 (Nathan Goldfinger of the AFL-CIO).

157. On this phenomenon see Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws,* 68 HARV. L. REV. 745 (1955).

charge across the board in 1967.[158] The restoration, moreover, was enacted in a form more generous than that intended by the Administration, because of pressure from the business community.[159]

The investment credit may have economic disadvantages as well, when turned on and off for short-run policy purposes. Aside from the overindulgence of the restoration in 1967, the suspension probably did have an impact on the timing of investment. Much investment expenditure was probably postponed, in anticipation of the eventual restoration of the credit. But this impact may have been harsh and inequitable. The sudden increase in costs must have caught many firms already committed to projects. Since the avowed aim of suspension was to deter investment, the Administration had to spare any firm already committed by binding contract. But anything less than a legal contract would not qualify for the exemption, not even an economic commitment represented by a large advance outlay. Firms constructing an equipped building would still qualify for the accelerated depreciation if the construction was fifty per cent completed;[160] this figure is clearly arbitrary. But the "binding contract" rule was equally arbitrary, because of the informality of many business dealings and the gradualness of many economic commitments. But any looser standard would have become a vast loophole. One would guess, moreover, that if suspension is ever expected to be used again for fiscal-policy purposes, businessmen will make more use of "binding contracts" and develop informal ways of untying themselves, to preserve the flexibility they want.

Understandably, the Administration now once again regards the investment credit as a permanent feature of the Code. The 1966 suspension is regarded as exceptional — the response to a unique, war-stimulated boom in the capital goods sector.[161]

Use of the income tax may be less subject to the special and divisive pressures to which the investment credit is vulnerable. While the

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158. *Hearings on H.R. 6950 (Restoration of the Investment Credit and Rapid Depreciation) Before the House Committee on Ways and Means,* 90th Cong., 1st Sess. 14, 18 (Rep. Byrnes), 20 (Rep. Ullman) (1967).

159. *See* n. 24 *supra.*

160. 80 Stat. 38.

161. *Hearings on H.R. 6950 (Restoration of Investment Credit and Rapid Depreciation) Before the House Committee on Ways and Means,* 90th Cong., 1st Sess. 11-12 (1967) (Henry Fowler).

Code may be riddled with "special provisions,"[162] an across-the-board change in personal and corporate income taxes has an aura of inherent equity. This is why the opponents of such tax changes are more likely to dispute the need for the change than to attempt to obtain special exceptions.

Most economists seem to agree that the personal income tax is the best instrument for countercyclical tax policy.[163] It has the broadest base and the greatest revenue yield. It is relatively simple to administer, and, because of the withholding system, it has an immediate effect on disposable income.[164] Sixty per cent of the consumers' response takes place within three months.[165] The corporate income tax could be manipulated simultaneously, either for reasons of equity or to influence investment demand. The effect of changes in corporate tax rates is immediate,[166] but it may not be great.[167] The personal income tax, however, affects investment indirectly via its impact on consumption, sales, and capacity utilization. Together, the corporate and individual income taxes may influence a wider range of investment — including inventories and accounts receivable — than any change in the investment credit.[168]

Furthermore, the impact of a change in the personal income tax is general without being blunt, even with respect to the investment it induces. Consumption of durable goods is usually the most responsive to changes in disposable income, and the durable goods industries are also the most affected by recession and unemployment or inflation.[169] Thus a significant degree of selectivity is built into a general

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162. Surrey, *The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted,* 70 HARV. L. REV. 1145 (1957); Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws,* 68 HARV. L. REV. 745 (1955). *But cf.* Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform,* 80 HARV. L. REV. 925 (1967).

163. *See, e.g., Tax Changes Hearings, supra* note 114, at 6 (Harvey E. Brazer), 9 (E. Cary Brown), 26 (C. Lowell Harriss), 65 (Carl S. Shoup), 233 (Stanley S. Surrey); J. PECHMAN, FEDERAL TAX POLICY 14 (1966); R. GOODE, THE INDIVIDUAL INCOME TAX 307 (1964).

164. A change in withholding rates can be made effective in seven days. R. GOODE, THE INDIVIDUAL INCOME TAX 302 (1964).

165. 2 ROYAL COMMISSION ON TAXATION, REPORT 62 (Can. 1966).

166. If the corporation pays on an accrual basis, the rate change is effective immediately.

167. Some economists believe that the corporations merely shift this burden onto the consumer in the form of higher prices. Other economists disagree. *See* J. PECHMAN, FEDERAL TAX POLICY ch. 5 (1966).

168. *Tax Changes Hearings, supra* note 114, at 243 (Stanley S. Surrey).

169. 2 ROYAL COMMISSION ON TAXATION, REPORT 64 (Can. 1966).

change in individual income tax.

This overall superiority of the individual income tax from the point of view of stabilization policy settles many questions raised about discretionary or standby schemes. In particular it may make the issue of "neutrality" academic. Most proposals for reform of the tax legislative process require that the short-run tax changes be neutral in respect to the distribution of the tax burden, in order to minimize controversy and to keep short-run measures distinct from long-run tax policy.[170] But some economists have suggested that a countercyclical tax measure could not be neutral and effective at the same time. Instability can originate in various sectors — investment goods or consumer goods, cost-push or demand-pull, balance of payments, supply rigidities, and so forth. Effective tax policy for stabilization may require a specific focus.[171]

Advocates of reform have conceded this.[172] But this admission did not prevent the Subcommittee on Fiscal Policy, for example, from recommending a uniform percentage addition to or subtraction from corporate and individual income tax liabilities as part of a plan of congressional standby legislation. A strict time limit on the short-run measures (unless they are positively reenacted) would prevent them from becoming permanent features of the Code. And the individual income tax (with the corporate tax thrown in for equity's sake) was simply considered the best tax instrument to enshrine in the legislative reform.[173] Similarly the Carter Commission in Canada was not persuaded that specific tax weapons aimed at investment were necessary: "[M]ore general means of controlling demand are usually in order."[174] While there is no reason to rule out the countercyclical use of other specific measures such as the investment credit or accelerated depreciation, the income tax is a potent and proven weapon, and those who have based reform proposals on it have not misplaced their reliance.

There is another aspect of "neutrality" that leads us into some of the political issues raised by the reform proposals. The distribution of the tax burden is a matter of long-run social policy which a short-run tax change ideally would not affect. The tax change should

170. *Tax Changes Hearings, supra* note 114, at 72 (Henry C. Wallich), 233-34 (Stanley S. Surrey).
171. *Id.*, at 70 (Henry C. Wallich), 302-03 (Norman B. Ture).
172. *Id.*, at 70 (Henry C. Wallich); TAX CHANGES REPORT, *supra* note 113, at 9.
173. TAX CHANGES REPORT, *supra* note 113, at 9.
174. 2 ROYAL COMMISSION ON TAXATION, REPORT 65 (Can. 1966).

therefore be even-handed in respect to all income brackets as well as in respect to the investment and consumption sectors of the economy.[175] Otherwise a short-run tax measure will open up the supremely political question of *cui bono*.

For this reason, proposals for tax reform must be kept distinct from proposals for short-run tax devices. In 1967, the Johnson Administration recommended tax reform, but in a different section of the Economic Report from that which proposed the income tax surcharge.[176] The President thus hoped to avoid the pitfall encountered in 1963 by his predecessor, who linked tax reduction and tax reform and whose bill took thirteen months to become the Revenue Act of 1964.[177]

## V. Politics and Policy

The political sensitivity of tax policy is the major practical obstacle to reform of the tax legislative process. There are competing interests to reconcile, not only among different segments of the community, but also between Congress and the executive. Congress is not about to pass a Gulf of Tonkin Resolution in the tax field. All of the reform proposals discussed in this Note would limit Congress's present control over tax legislation. But policy as well as power is at issue: Which branch of the government can manage tax policy most effectively and responsibly? Is there enough of a consensus on economic policy to permit a grant of authority to the executive, or even to permit agreement on the format of congressional standby legislation?

The principal argument for presidential discretion is that Congress is too slow, with its duplicative hearings, parades of witnesses representing special interests, unlimited debates, and self-willed committee chairmen. But critics of reform have responded that the "legislative lag" is not as significant as the "recognition lag," that is, the delay

175. The most even-handed technique would seem to be a change of a *uniform percentage of total taxable income*, that is, a uniform increase or reduction in all rates by a certain number of percentage points. This was the method of President Kennedy's 1962 proposal. *See* pp. *supra*. The Commission on Money and Credit recommended a change in the *first-bracket rate alone*. *See* n. 41 *supra*. This is more progressive in the case of tax reduction but more regressive when taxes are raised. Another device would be a *uniform percentage change in tax liabilities*. If a 10% change is used, this would move a 20% rate up or down two points, and a 70% rate up or down seven points. This is more progressive on the upswing, but more regressive on the downswing, than the Kennedy proposal. It is the technique of the "surcharge" as well as of the standby schemes of Wright Patman, the Carter Commission, and West Germany. *See* p. 273 & note 39, p. 281 & note 92, p. 275 *supra*.

176. Economic Report of the President 1967, at 9 (surcharge), 21 (reform).

177. *See* Economic Report of the President 1963, at xiii-xxii.

which occurs while the executive is making up its mind. This "recognition lag" may be due either to forecasting difficulties or to electoral considerations.[178] In 1958, President Eisenhower denounced as "political Cassandras" those who were predicting a recession which in fact had already begun.[179] In 1960, according to a member of the Council of Economic Advisers at the time, the approach of an election was a factor delaying official recognition of a recession in that year.[180] The unpopularity of tax increases is to be expected, but there can also be political inhibitions about requesting tax reductions. In 1958, the Eisenhower Administration apparently feared that a request for a reduction would imply a public admission that a slump was imminent and that corrective action was needed.[181]

On the other hand, it can be argued with respect to forecasting that economic predictions in recent years have had a "fairly high degree of success."[182] Moreover, as the Subcommittee on Fiscal Policy has urged, the best way to develop stabilization skills is to try short-term tax changes until we learn how to use them with utmost effectiveness. Inaction may be worse than any mistakes.[183] One might add that mistakes would not be so crucial if there were a discretionary or standby procedure for making rapid readjustments.

As for electoral considerations, it can be shown that there is no clear historical correlation between election years and federal tax measures. As Table II indicates, there is no propensity for tax reductions to occur in election years; interestingly enough, most tax *increases* occurred in election years.[184] Thus there is no evidence that Administrations are as a rule inhibited in raising taxes or profligate in reducing them, for electoral reasons.

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178. *Tax Changes Hearings, supra* note 114, at 299 (Norman B. Ture); *Report Hearings 1962, supra* note 44 at 673-74 (Emerson Schmidt of the U.S. Chamber of Commerce).

179. Excerpts from Remarks at Republican National Committee Breakfast, January 31, 1958, in PUBLIC PAPERS OF THE PRESIDENTS OF THE UNITED STATES: DWIGHT D. EISENHOWER 1958, Item [26] 135, 138 (1959).

180. *Economic Policy for 1962: A Symposium*, 44 REV. ECON. & STAT. 12 (1962), *cited in* LEWIS, *supra* note 25, at 274 (Henry Wallich). *Cf. Tax Changes Hearings, supra* note 114, at 299 (Norman B. Ture).

181. LEWIS, *supra* note 25, at 235.

182. KEISER, *supra* note 6, at 350.

183. TAX CHANGES REPORT, *supra* note 113, at 4-5.

184. *Hearings on a Review of the Report of the Commission on Money and Credit Before the Joint Economic Committee*, 87th Cong., 1st Sess. 190 (1961) (Carl S. Shoup).

TABLE II: MAJOR REVENUE ACTS AND ELECTION YEARS, 1913-1967*

| TAX INCREASES | TAX REDUCTIONS |
|---|---|
| 1913 | 1921 |
| 1916** | 1924** |
| 1917 | 1926* |
| 1918* | 1928** |
| 1932** | 1938* |
| 1933 (N.I.R.A.) | 1939 |
| 1934* | 1945 |
| 1935 | 1948** |
| 1936** | 1954* |
| 1937 | 1958* (Techn. Amends. & Small Business) |
| 1940** | 1962* |
| 1940** (indiv. income tax) | 1964** |
| 1941 | 1967 (Restoration of Inv. Credit) |
| 1942* | |
| 1943 | |
| 1944** | |
| 1950* | |
| 1950* (Excess Profits) | |
| 1951 | **Presidential election year |
| 1956** (Fed.-Aid Highway) | *Congressional election year |
| 1966* (Tax Adjustment) | |
| 1966* (Suspension of Investment Credit) | |

*Adapted, with additions, from *Hearings on a Review of the Report of the Commission on Money and Credit Before the Joint Economic Committee,* 87th Cong., 1st Sess. 191 (1961) (Carl S. Shoup).

In addition, a great deal has occurred since 1958 and 1960 to make a repetition of that experience unlikely. The 1960 election may have shown that a recession is more damaging politically than the measures necessary to remedy it. The 1964 tax reduction has proved that countercyclical tax policy works.[185] The conscious Keynesianism of Administration policy in the last seven years is bound to have had an educational effect on the public and thereby altered the electoral climate for economic policy-making.[186]

How great a consensus is there? This question is crucial to the prospects for reforming the tax legislative process. Agreement is needed, not only on the desirability of a particular tax-rate change, or on the format of a standard standby tax measure, but on the role

185. A. Okun, *Measuring the Impact of the 1964 Tax Reduction* (paper read before the American Statistical Assoc., Phila., Pa., Sept. 10, 1965), *cited in* TAX CHANGES REPORT, *supra* note 113, at 14, *and in* W. HELLER, NEW DIMENSIONS OF POLITICAL ECONOMY 72 & n. 15 (1967). *See also* Table in *Hearings on the January 1967 Economic Report of the President Before the Joint Economic Committee,* 90th Cong., 1st Sess., pt. 1, at 210 (1967).

186. *Cf.* W. HELLER, NEW DIMENSIONS OF POLITICAL ECONOMY 11-12 (1967).

of federal tax policy. If the delays encountered in tax legislation are due to the lack of such consensus, it is disingenuous to seek a procedural reform which will bypass the Congress. The legislature is supposed to be the arena of dispute over public policy. As a practical matter, those individual leaders in Congress who do not accept the worldview of the welfare state cannot be expected to approve or permit a procedural reform designed to circumvent their opposition.[187]

The sad fate of the 1967 surcharge proposal should remind us of the limits of the consensus. Representative Thomas B. Curtis, a member of the Joint Economic Committee, has explained his theory of the 1964 tax reduction:

> "[O]ur tax rates were so high that they were impeding the growth of the [tax] base and we had to get the rates down.
>
> "In contrast to that was the theory that the administration spokesmen advanced, that we had to increase aggregate demand. The test of which theory was applied involves taking a look at the expenditures level because the first theory required expenditure restraint, the second did not."[188]

The Curtis theory is shared by other conservatives, including Representative Wilbur Mills. This reasoning explains why the Administration had to pledge to keep Fiscal 1965 expenditure below $100 billion in order to rescue the Revenue Act of 1964.[189] The essential premise of this view is that expenditure reduction is desirable per se because it reduces the scale of the public sector in the American economy and the role of the federal government in American society. Accordingly, the 1964 tax reduction was beneficial because it stimulated the growth of the private sector and provided an incentive to reduce the federal budget; the surcharge proposed in 1967 was suspect because the additional revenue from it might feed the further growth of the public sector — unless the President once again took the pledge. To Representative Mills, tax policy represents an attempt by the Administration to evade expenditure reduction.[190] The "axiom of the New Economics" which opened this Note — that tax policy is becoming the crucial weapon of modern fiscal policy — is thus square-

187. The Ways and Means Committee reportedly regards the present legislative procedure as adequate. N.Y. Times, March 21, 1966, at 1, col. 5.

188. *Hearings on the January 1966 Economic Report of the President Before the Joint Economic Committee*, 89th Cong., 2d Sess., pt. 1, at 64 (1966).

189. *See* N.Y. Times, Jan. 9, 1964, at 17, col. 1.

190. *See* Text of Announcement and Address by Representative [Wilbur] Mills on Taxes and Expenditures, Nov. 20, 1967, in N.Y. Times, Nov. 21, 1967, at 74, cols. 2, 6.

ly in conflict with this conservative philosophy.[191]

But the consensus may be wider and the impasse narrower than the foregoing suggests. Basic empirical Keynesian premises about the functioning of the modern economy are now widely accepted. "We are all Keynesians now," Milton Friedman has said.[192] Since the success of the 1964 tax reduction, those critics who argued against legislative reform on the ground that tax policy was unproven[193] have lost one of their major arguments. In addition, we have seen the bipartisan support which all three of the reform proposals have received.[194] It must be that wide agreement already exists on the need for speed in legislating tax changes. Such agreement ought to be embodied in a procedural reform — a reform which permits speedy implementation of tax policy while preserving Congress's ultimate power to determine what that policy is. The scope of the consensus and the political temperature can easily be tested by a new, detailed, and energetically prosecuted presidential recommendation.

## VI. Conclusion

This Note has set forth three proposed techniques of improving the process of legislating tax changes for economic stability and growth, and has attempted to explore some of the issues that these proposals raise. Neither constitutional command, economic complexity, nor political controversy is an insuperable barrier to reform. Six years have now elapsed since a President last made a serious effort to bring about such reform. It is unfortunate that such efforts have not been continued. The next time such a proposal is made we may discover, not really to our surprise, that it is an idea whose time has come.

*Peter W. Rodman**

191. "I believe that tax policy should be limited to collecting revenue for duly authorized governmental expenditures as efficently as possible and with the minimum amount of impact upon economic policy." Rep. Thomas B. Curtis, Dec. 4, 1962, in Tax Foundation, Inc., Proceedings of a Conference on Federal Tax Reform in 1963, at 32 (1963). "We must not let ourselves be put into the position of raising and lowering the hemline of taxation from season to season merely to make the merchandise more salable." Rep. Wilbur Mills, Feb. 12, 1967, *quoted in* 25 Cong. Q. Weekly Rep. 273 (No. 8, Feb. 24, 1967).

192. *Quoted in* 86 Time, Dec. 31, 1965, at 65.

193. *E.g., Report Hearings 1962, supra* note 44, at 474 (1962) (Raymond L. Saulnier).

194. See pp. 273-74, 286, 288 *supra*.

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## APPENDIX

# *STANDBY TAX REDUCTION AUTHORITY ACT OF 1962*

## A BILL

*To amend the Internal Revenue Code of 1954 to provide standby authority for temporary reduction in the individual income tax when needed to meet the objectives of the Employment Act of 1946.*

SECTION 1. *SHORT TITLE.*
This Act may be cited as the "Standby Tax Reduction Authority Act of 1962."

SECTION 2. *FINDINGS AND DECLARATION OF POLICY.*
It is the continuing policy and responsibility of the Federal Government as set forth in the Employment Act of 1946 to coordinate and utilize all its powers and resources to promote maximum employment, production, and purchasing power. One means of meeting such objectives is prompt temporary reduction in individual income tax rates when economic circumstances require it. It is therefore declared desirable to adopt a procedure to provide for the effectuation of such reduction more speedily than by means of the enactment of specific legislation.

SECTION 3. *AMENDMENTS OF INTERNAL REVENUE CODE.*
(a) Temporary Rate Adjustments.—Part I of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (relating to tax on individuals) is amended by redesignating section 5 as section 6 and by inserting after section 4 the following new section:

*SEC. 5. TEMPORARY TAX ADJUSTMENTS.*
"(a) In General.—Whenever tax is reduced for a period under a plan of tax rdeuction which takes effect as provided in subsection (b) (3), then, in lieu of the tax imposed by section 1 or 3, there shall be imposed upon the taxable income of every individual for any taxable year which includes any part of such period—

"(1) Calendar year taxpayers.—In the case of individuals computing taxable income on a calendar year basis, the tax set forth in regulations prescribed by the Secretary or his delegate in accordance with such plan and subsection (c), and

"(2) Other taxpayers.—In the case of individuals computing taxable income on a fiscal year basis or for a period of less than 12 months, the tax computed under section 21 by applying the reduced rate for the reduction period and the statutory rate for the nonreduction period.

For purposes of any reference to the tax imposed by section 1 or 3, the tax imposed by this section shall be considered as imposed by section 1 or 3, as the case may be.

"(b) Authority of the President.—

"(1) Plan of tax reduction.—Whenever the President determines that a temporary reduction in the tax imposed by section 1 or 3 is needed to promote the attainment of maximum employment, production and purchasing power, he shall prepare and submit a plan of tax reduction to Congress (whether or not Congress is then adjourned *sine die*). Such plan shall state—

"(A) that in the judgment of the President, a temporary reduction in the tax imposed by section 1 or 3 is required to meet the objectives of the Employment Act of 1946;

"(B) the reasons upon which he formed this judgment;

"(C) the extent to which the tax imposed by section 1 or 3 is to be reduced; and

"(D) the period during which such tax reduction is to be applicable.

Such plan shall be submitted to both Houses of Congress on the same day. If Congress is adjourned *sine die* on the day such plan is submitted to Congress, such submission shall be effected by filing such plan with the Clerk of the House of Representatives and with the Secretary of the Senate. The President may submit a new plan of tax reduction during any period of tax reduction under the authority of this section, but may not submit a plan of tax reduction which would cause tax reductions under the authority of this section to be in effect for an uninterrupted period of more than one year.

"(2) Limitations on plans of tax reduction.—

"(A) Extent of tax reduction.—Under a plan of tax reduction, each rate used to compute the tax imposed by section 1 or 3 shall be reduced by the same number of percentage points, but no reduction shall exceed five percentage points.

"(B) Maximum period of tax reduction.—The period of tax reduction provided under any plan of tax reduction shall not exceed six months, except as provided in paragraph (4).

"(C) Effective date of period of tax reduction.—The beginning date of the period during which the tax reduction is to be applicable shall be the thirty-first day after the date on which the plan of tax reduction is submitted to Congress (whether or not Congress is then adjourned *sine die*).

"(3) Taking effect of plan of tax reduction.—A plan of tax reduction submitted to Congress by the President under this section shall take effect in accordance with its terms, unless within thirty calendar days following the date of its submission to Congress, there has been passed by the two Houses of Congress a concurrent resolution stating in substance that Congress does not favor such plan. Notwithstanding the provisions of paragraph (2) (B) if Congress is adjourned *sine die* on the day on which the plan is submitted to it, the period during which the tax reduction is applicable under such plan shall terminate not later than the thirty-first calendar day following the date on which Congress convenes after such submission.

"(4) Extension of period of tax reduction.—Whenever in accordance with this section the President prepares and submits a new plan of tax reduction during a period of tax reduction under the authority of this section, such period shall be extended, if it would otherwise expire without regard to this paragraph, to whichever of the following dates is applicable.

"(A) the date of beginning of the period of tax reduction under such new plan, or

"(B) the fifteenth calendar day after the day on which such new plan is disapproved by Congress in accordance with paragraph (3).

"(5) Termination by President.—If, during a period of tax reduction under authority of this section, the President determines that a reduction in the tax imposed by section 1 or 3 is no longer needed to promote the attainment of maximum employment, production and purchasing power, he may issue an Executive order finding that such need no longer exists and terminating such reduction on the date specified therein, but such date shall not be earlier than the fifteenth calendar day after the day on which such order is issued.

"(c) Adjusted Tax for Calendar Year Taxpayers. —

"(1) Authority of the Secretary or his delegate. — Whenever a plan of tax reduction submitted to Congress by the President under this section takes effect, the Secretary or his delegate shall —

"(A) determine, in accordance with paragraph (2), composite adjusted rates for individuals computing taxable income on the basis of a calendar year which includes any part of a period during which tax is reduced under such plan, and,

"(B) prescribe regulations setting forth modified tax tables computed upon the basis of such composite adjusted rates.

"(2) Determination of composite adjusted rates. — Each composite adjusted rate referred to in paragraph (1) (A) shall be the sum of —

"(A) the rate obtained by multiplying each reduced rate by a fraction the numerator of which is the number of days in the reduction period and the denominator of which is the total number of days in the adjustment year, and

"(B) the rate obtained by multiplying each statutory rate by a fraction the numerator of which is the number of days in the nonreduction period and the denominator of which is the total number of days in the adjustment year.

The composite adjusted rate so determined shall be rounded to the nearest fraction of a percentage point as determined under regulations prescribed by the Secretary or his delegate.

"(d) Definitions. — For purposes of this section —

"(1) The term 'adjustment year' means any taxable year which includes any part of a period during which tax is reduced under authority of this section.

"(2) The term 'reduction period' means any period during which tax is reduced under authority of this section and any extension thereof under paragraph (b) (4) of this section.

"(3) The term 'nonreduction period' means that period of an adjustment year which is not a reduction period.

"(4) The term 'statutory rate' means each rate used to compute the tax imposed by section 1 or 3.

"(5) The term 'reduced rate' means the rate obtained when each statutory rate is reduced by the number of percentage points specified in a plan of tax reduction which has taken effect under this section."

(b) Temporary Reduction in Wage Withholding. — Section 3402 of chapter 24 of the Internal Revenue Code of 1954 (relating to income tax collected at source) is amended by adding at the end thereof the following new subsection:

"(k) Temporary Withholding Tax Adjustments. —

"(1) Authority of the Secretary or his delegate. — If a plan of tax reduction takes effect under section 5, the Secretary or his delegate shall —

"(A) prescribe regulations setting forth a reduced withholding percentage rate equal to the percentage rate set forth in subsection (a) less the number of percentage points by which each rate of tax imposed by section 1 or 3 is reduced by such plan, and

"(B) prescribe regulations setting forth modified tax tables computed upon the basis of the reduced withholding percentage rate referred to in subparagraph (A).

"(C) prescribe regulations setting forth the period during which tax shall be deducted and withheld at reduced rates. Such period shall consist of the same number of days as the number of days in the period of tax reduction authorized under section 5 and shall begin not later than the sixteenth day after the date of beginning of the period of tax reduction under section 5.

"(2) Applicability of reduced withholding tax.—

"(A) In lieu of the tax to be deducted and withheld under subsection (a) or (c) —

"(i) every employer subject to subsection (a) shall deduct and withhold at the reduced withholding rate set forth in regulations prescribed under paragraph (1) (A), and

"(ii) every employer subject to subsection (c) shall deduct and withhold the reduced withholding amounts in accordance with tables in regulations prescribed under paragraph (1) (B).

For purposes of any reference to the tax deducted and withheld under subsection (a) or (c), the tax deducted and withheld under this subsection shall be considered as deducted and withheld under subsection (a) or (c), as the case may be.

"(B) The tax under subparagraph (A) shall be deducted and withheld during the period set forth in regulations prescribed under paragraph (1) (C)."

SECTION 4. *EFFECTIVE DATES.*

This Act and the amendments to the Internal Revenue Code of 1954 contained in section 3 shall be effective on the day following the date of enactment of this Act.

# BOOK REVIEW

THE RECONSTRUCTION AMENDMENTS' DEBATES. *Alfred Avins,* Ed.*; Richmond: The Virginia Commission on Constitutional Government, 1967; pp. xxxii, 761; $4.50.

The constitutional development of the United States has, of course, not progressed at an even pace. Great social and governmental crises have called forth episodes of constitution-making, to which have succeeded periods of relative calm while the nation adjusted itself to its new fundamental law and overcame its own surprise at what it had done. The beginning of the episodes of creative amending action can only be marked by historical events arbitrarily chosen in a constitutional continuum. One way to designate the time of our first constitution-making is to begin with the unsuccessful Plan of Union sponsored by Benjamin Franklin and Thomas Huchinson and debated before the Albany Congress in June, 1754.[1] That creative era ended with Virginia's ratification of the first ten Amendments on December 15, 1791.[2] Probably the next great era of constitutional creativity came with the war of 1861-1865; but that episode began years before gunfire at Fort Sumter, and lasted at least a decade after Appomattox. The Thirteenth, Fourteenth and Fifteenth Amendments registered, in sweeping terms, the constitutional resolution of the conflict. Both of these periods of constitutional change were marked by amendments formally enacted under the Fifth Article of the Constitution. The third conspicuous era of development began about 1930 and still continues; this time the evolution has come about through a series of decisions handed down by the Supreme Court of the United States.

All three phases of active development have consisted, fundamentally, in augmentation of the power of the central government; all three have thus in effect limited the "sovereign" powers of the several States. All three have, naturally, evoked protests from States when the expanded national power has run counter to what State officials or citizens have desired or have thought lawful. Examples of adverse reaction are legion. Of the Supreme Court's decision that

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1. S. Morrison, *Oxford History of the American People* 161 (1965).

2. Virginia ratified twelve amendments on that day, but only ten of them had then received or ever did receive enough ratifications to become part of the Constitution.

Virginia's attempt to escheat the Fairfax lands had been invalid, Judge Spencer Roane of the Virginia Court of Appeals wrote in an 1815 opinion ". . . no calamity would be more to be deplored by the American people, than a vortex in the general government, which should ingulph and sweep away, every vestige of the state constitutions."[3] In 1962, the Governor of Mississippi "issued a series of proclamations calling upon all officials of the state to prevent and obstruct" the effectuation of federal court orders to admit a negro student to the state university.[4] In 1964, Mr. Garrett Byrne, President of the National Association of District Attorneys said of *Escobedo v. Illinois*[5] and *Massiah v. United States*[6] that if five men sat down to think carefully how to destroy the country they could not do more harm to law enforcement than the then Supreme Court majority.[7]

*The Reconstruction Amendments' Debates,* in commendable contrast to many other state reactions against Supreme Court adjudications, is a dignified publication of congressional materials, useful to those who support, as well as those who disapprove of, the recent trend of constitutional decisions. The Virginia Commission on Constitutional Government in its Preface, clearly indicates its antipathy toward what it considers amending the Constitution by judicial decision, but these sentiments are expressed in the form of courteous argumentation.

The Virginia General Assembly created the Commission by a 1958 Act,[8] which required it to "develop and promulgate information concerning the dual system of government, federal and state, established under the Constitution of the United States and those of the several states." The Commission is empowered to "publish such information as it deems appropriate in order to acquaint the general public, both in this State and elsewhere, with the nature of the rela-

3. Martin v. Hunter's Lessee, 1 Wheat. 304 (1816). *See* Fairfax's Devisee v. Hunter's Lessee, 7 Cranch 603 (1813). *See also* Note, Judge Spencer Roane of Virginia: Champion of States' Rights—Foe of John Marshall, 66 Harv. L. Rev. 1242 (1953).

4. *See* United States v. Barnett, 330 F.2d 369, 376 (5th Cir. 1963); *certified question answered,* 376 U.S. 681 (1964).

5. 378 U.S. 478 (1964).

6. 377 U.S. 201 (1964).

7. *Quoted in* Boston Evening Globe, July 14, 1964, p. 26, col. 3. These three examples of adverse State reaction all were evoked by adjudication. But State sentiments hostile to proposed national legislation appear at numerous points in *The Reconstruction Amendments' Debates.* Barnett, in 1962, was reacting to federal troops as well as federal courts.

8. Chapter 223, Acts of Assembly 1958.

tionship between the individual states and the United States and the freedoms reserved to the states and their individual citizens under the Constitution of the United States."

Under this mandate the Virginia Commission, in 1967, published the volume here reviewed. It contains nearly 800 pages of congressional legislative history and debates, between 1849 and 1875, relevant, broadly considered, to the reconstruction amendments. The Commission's editor, Dr. Alfred Avins, has added a 32-page Reader's Guide with abundant bibliography. A 20-page index follows the legislative material. The book is a useful compilation of the debates, chronologically arranged, and will be a great convenience to those students of the period who find it difficult to gain access to the original printed records.

The Commission's Preface raises ancient questions of constitutional theory.

> [The] Virginia Commission on Constitutional Government gravely fears that, if the limitations on governmental power prescribed by "We, the people, . . ." in the Constitution can be reduced or eliminated, by some amendatory process not provided by the people in the Constitution, then law is no longer ruler and yields to the man or group of men who can thus alter the instrument made by "We the People."
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> The Commission's belief in the absolute necessity for adherence to the will of the governed as announced in the Constitution leads it to the further belief that such result can only obtain by interpreting every portion of the Constitution, including the amendments thereto, in accordance with the intent and understanding of the framers of the particular provision under consideration.
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> Consistent with this belief, the scope of *The Reconstruction Amendments' Debates* has been limited to congressional debates and reports. States cannot change the text of a proposed amendment; they can either ratify it, or reject it. Congress alone can alter a draft of a proposed constitutional amendment. Therefore, the understanding and intent of Congress is of prime importance in the proper construction and interpretation of the amendments.

Here appear assumptions of much significance in the theory of constitutional lawmaking. Under Article Five of the Constitution, legislatures or conventions in three-fourths of the States must ratify an amendment before it takes effect. Does this not create, for constitutional enactment, a sort of great Parliament of three houses: the Senate, the House of Representatives, and the ratifying bodies in the several States? True, the States can not amend proposals sent to them by the Congress; but is not the understanding by the States, of what they have ratified, a highly significant fact?

And to which of the debaters in the Senate or House shall we listen for authoritative construction? Whose "understanding and intent" is to govern us? One reads the debates of 1866 and finds many different shades of opinion. Thoughtful and high-minded men have been unable to point to a clearly defined meaning for "due process" intended by the draftsmen of the Fourteenth Amendment. The draftsmen clearly wished to give some valuable protection to every "person" against the State wrong; but definition of that wrong, and the degree of protection, were necessarily left for judicial determination. The words do not speak for themselves.

And are we quite ready to agree that the effect of constitutional norms even where their application when adopted was clear, may not, in fact should not change with social and technical change? In 1898, Mr. Justice Brown wrote for the Supreme Court, upholding an eight hour work day law in mines, smelters and ore reduction works —

> in passing upon the validity of state legislation under that Amendment [the 14th], this court has not failed to recognize the fact that the law is to a certain extent a progressive science. . . .[9]

One finds somewhat incredible a contention that Marshall's Court would have upheld under the Commerce Clause or any other clause a federal statute imposing a penalty on a farmer, measured by his excess over a nationally prescribed acreage of wheat, even when the wheat was consumed on the producer's own farm.[10] Few farmers have resented the benefits of the Agricultural Adjustment Act; regulation of commerce "among the several states" had a different meaning a century and a half after the Convention drafted Article I, § 8, Clause 3 of the Constitution.

The American polity functions remarkably well, on balance. It does so by a discreet intermingling of the popular and the aloof elements in our constitutional arrangement. We entrust to the legislative and the executive branches the functions of government in response to popular will. They operate in the full blaze and heat of political light, magnified by the national taste for exaggerated state-

9. Holden v. Hardy, 169 U.S. 366, 385 (1898).
10. Wickard v. Fillburn, 317 U.S. 111 (1942).

ment. They must perforce function under the continued pressure of coming elections. Their product, constitutional clauses or statutes, is necessarily general; they respond to popular demands which ordinarily are themselves unformulated urges, often more emotional responses than calculated devices to produce a social effect. To produce a polity which functions satisfactorily we must have an organ of government which interprets the generalities of legislation so that they will answer appropriate social needs. This is best done by a body exempt from the necessities of popularity, elite in ability, generalist in its qualifications, respected for its detachment from the party considerations which in the 1780's were called "faction." If the Supreme Court did not exist, that is to say, we should have had to create it much in its present form. Law making is a complex and important power, much too important to leave solely to legislators.

There must be some play in the joints of the constitutional structure if it is to stand the stresses of a changing civilization. The formal amending process, quite properly, is difficult to operate. We do better to adapt our minor constitutional tolerances to the needs of the times through the case-by-case judicial process. We have been doing this ever since Marshall's court made the newly invented steamboat useful to hold a continent together.[11] Few of us would really want it otherwise.

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11. Gibbons v. Ogden, 9 Wheat. 1 (1824).

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