

# COMMONWEALTH OF SYMMETRICA

## INCOME TAX ACT 20\*\*

### COMMENTARY

#### BACKGROUND

1. The main purpose of this Commentary is to explain briefly the presentation and form of the Commonwealth of Symmetrica Sample Income Tax Law (the “Sample”). The Background to this Commentary is as much about explaining what the Sample is not as it is about explaining what it is. The Sample is an example of a relatively comprehensive income tax law and one particular drafting style. It is not an example of an ideal income tax, if it were possible to draft one in any case.
2. For example, there are many areas of income tax theory where experts do not agree. The taxation of income on a realisations basis is one as is whether the exemption or credit method should be used to provide foreign tax relief and the treatment of savings. Even in areas where experts do agree that a particular approach is correct in theory, many will further agree that the theoretically correct approach is not a practical one from an implementation perspective. The identification of where an in-kind benefit constitutes income (and is therefore included in calculating taxable income) or an expense constitutes human consumption (and is therefore not deductible) are two examples where a practical approach must be taken. Another is the level of control required to justify allocation of income of entities to their owners.
3. An income tax must be adapted to the circumstances in which it is to be applied. Different countries have different social values, different social structures, different levels of resources, and different government funding arrangements, including level of reliance on other forms of taxation. An ideal income tax for one country is unlikely to be ideal for another country. An income tax should be adapted to local conditions and can only be ideal in this sense.
4. The Sample is not adapted to any particular country’s circumstances. One of its primary objectives is that it can readily be adapted for use by particular countries. The particular countries towards which it is targeted are developing countries with an Anglo-Saxon based legal system. However, it may also be of interest to other countries including developed countries engaged in tax simplification projects. The Anglo-Saxon influence is apparent on the face of the Sample and, particularly, the terminology used. Nevertheless, the Sample departs in many respects from the traditional United Kingdom approach to income tax. For example, the Sample does not adopt the traditional United Kingdom distinction between income and capital.
5. The Sample purports to be relatively complete and comprehensive. These two aspects require further explanation. It is complete in the sense that its provisions cover most all topics that should be treated in an income tax. Further, these provisions are fully cross-

referenced and heavily integrated. It has been decided not to adopt a modular approach under which alternate provisions are provided demonstrating different approaches to a particular policy issue. Different approaches to particular policy issues invariably involve adjustment of more than one provision, which makes the modular approach very difficult, if not impossible, to present in a complete form. The Sample adopts only one policy approach to particular issues. This does not suggest that the approaches adopted are ideal or the best. Another of the purposes of this Commentary is to identify the policy options adopted and point out some different approaches.

6. The Sample also purports to be comprehensive. The tax base is broad and the exemptions limited. However, except in isolated cases, a realisations rather than accrual tax base is adopted. The Sample addresses many difficult tax base issues. Many of these issues are not even appropriately addressed by many developed countries, at least in legislative form. Examples of these types of issues are:
  - tax base erosion by non-resident controlled entities by repatriation of profits through payments subject to low-final withholding taxes (usually only directly addressed in the context of interest by thin capitalisation rules);
  - the treatment of long-term contracts (which involve the potential for tax deferral);
  - the treatment of annuities, instalment sales, and finance leases (consistently with interest paid on a loan);
  - a comprehensive set of source rules covering income, losses, gains, and amounts included or deducted in calculating income (usually dealt with in part if at all);
  - the coverage of liabilities under transactional basis (capital gains) treatment (which are often ignored in legislation); and
  - value shifting between interests and liabilities held in entities (an issue either ignored or only dealt with in isolated cases).
7. It is not suggested that all countries need these rules or that they should adopt them as in the Sample. Rather, the purpose of the Sample is to demonstrate the issues that a country should consider when drafting or redrafting an income tax. In this way, the Sample serves as a useful checklist of things to be considered and provides but one example of how to address particular issues. Keen attention has been paid to structural issues. Too many countries' income tax laws are littered with provisions that appear under headings to which they do not relate and only cover part of the generic issue because that was the part that was initially causing a problem. They find later on that variations of the problem continue to arise because they did not address the issue from a structural perspective in the first place.
8. Some further general explanation is required with respect to the approach to drafting. Some will find the approach too complex and others will find that it is not sufficiently specific in particular places. In particular, those favouring a principles approach to drafting, such as that adopted by Continental Europe, may find the use of definitions overwhelming. However, such an approach typically assumes a particular legal system underpinning the income tax law and relies on that legal system to fill the gaps that the income tax law does not cover. Many countries, particularly developing countries, do

not have a sufficiently sophisticated legal system such that it may be assumed that a particular issue will be appropriately covered by some other law, e.g. accounting law. The approach of the Sample is to assume the lack of a sophisticated legal system. It seeks to cover virtually all matters pertaining to the income tax law. That is, the Sample seeks to be self-standing.

9. Nevertheless, the Sample does not seek the level of sophistication adopted in many developed countries' income tax laws. Often this sophistication is superficial and only hides a poorly structured or drafted income tax, using a number of provisions to deal with issues that are dealt with by substantially fewer provisions in the Sample. In any case, as mentioned above at paragraph 4, the Sample is primarily targeted at developing countries where the sophistication often sought by developed countries is not justified.
10. Not only does the Sample seek to be comprehensive but it also seeks to be uniform. If it is possible to deal with a number of issues using only one concept, then the Sample does so. Again, this approach is lacking in many income tax laws. It is perhaps this goal of uniformity rather than that of comprehensiveness that has caused a lengthy general definitions section. The general definitions section is in many ways the map to the Sample. It is this section that ensures that singular concepts are used consistently throughout the Sample.
11. In most cases, the general definitions section does not define a term but directs the reader to the section where a particular term or phrase is defined. Where the meaning of a particular word or phrase is central to a particular Division or Subdivision, the term is often defined in a central concepts section at the beginning of the Division or Subdivision. This approach is felt superior to one in which all definitions are collected in one definitions section. Placing related definitions within close proximity of one another provides a greater insight into the approach adopted by the Sample. If these related definitions were scattered throughout a very large definitions section, this advantage would be lost.
12. A further tool is provided in order to assist with navigation through the Sample and identification of defined terms and phrases. All terms and phrases appearing in the Sample that are intended to be used in the sense defined in the general definitions section are underlined. This is intended to alert the reader that a particular term or phrase is used in the defined sense. Finally, in the usual way, if a defined term is only used in one section, the term is defined at the end of that section and not in the general definitions section.
13. The section numbering used in the Sample is also worthy of short comment. It accepts the inevitability that income tax laws will be amended. In order to make provision for amendment, section numbers are reserved at various points throughout the Sample. The general approach is to begin each Part, Division, or Subdivision with a section number based on a multiple of five. This results in reserve section numbers at the end of each Part, Division, or Subdivision.

## **PART I: IMPOSITION OF INCOME TAX**

14. The Sample begins with the charging provision, section 1. The charging provision is the central provision of the Sample from which the rest of the Sample branches. It is the only section that imposes income tax. The Sample distinguishes the imposition of income tax and other "tax" imposed by the Sample. "Tax" is defined in section 205 and includes not only amounts charged under section 1 but amounts charged under other provisions such as interest and penalties.
15. Income tax is imposed under section 1 for each "tax year". Amounts used in calculating income tax must, therefore, be allocated to specific tax years. This allocation process is primarily detailed by Subdivision B of Division II of Part II. The charging provision specifies that income tax payable is to be paid in accordance with the procedure in Part V.
16. Income tax is charged under four heads in section 1(1). The amount of income tax payable by a person for a tax year is the total of the amount payable under these heads for the year. The calculation process is different for each of these heads and is set out in the rest of the charging provision. The tax rates applicable follow in Division II. Income tax is imposed on a "person". "Person" is another central concept that is defined in section 105 to mean an individual or an entity (partnership, trust, company, or foreign branch). Income tax treatment varies dramatically under the four heads depending on whether the person deriving the income is an individual, an entity, or a non-resident person. The following discussion considers taxation under these income tax heads by reference to these different types of persons.

### **Individuals**

17. The first head of charge to income tax is the traditional profits base. The concept of "taxable income" is used to represent profits. Taxable income is calculated in accordance with Division I of Part II, see the discussion below at paragraphs 33 to 96. Income tax payable under this head is primarily calculated under section 1(3) by applying the tax rates set out in section 5 to the relevant individual's taxable income. The resulting amount is reduced by "offsets" to arrive at tax payable. This term is defined in section 345 by reference to personal, medical costs, and foreign tax offsets. The policy underlying these offsets is discussed in the Commentary relevant to the sections under which these offsets are calculated, see the discussion below at paragraphs 218 to 222 and 311 to 316. Often an amount that reduces tax otherwise payable in this manner is referred to as a "tax credit". The Sample only uses the term "tax credit" for what are effectively pre-payments of income tax made during the year on account of the end of year tax liability under the first head of charge to income tax. For example, tax credits are available for non-final withholding tax and tax paid by instalment. Excess tax credits are refundable under the Sample, see section 301 and the discussion below at

paragraph 365. By contrast, there is no provision for the refund of excess offsets but often they may be carried forward under the relevant calculation provision.

18. Section 1(4) is an exception to the calculation under section 1(3). This provision effectively turns wage withholding tax into a final withholding tax in certain circumstances. This has the administrative advantage of reducing, potentially dramatically, the number of returns of income that have to be filed with the tax administration. As soon as an employee has more than one source of income or claims deductions for payments made by the employee it becomes difficult for the employer to accurately determine the tax payable by the employee. This is one reason why employees are essentially denied deductions in calculating taxable income, see the discussion below at paragraph 69. Similarly, the final nature of the wage withholding tax is withdrawn where an employee claims tax rate averaging or, for payments not made through an employer, a medical costs offset or reduction in taxable income for retirement savings contributions. These are matters that are difficult for employers to substantiate, see section 236 and the discussion below at paragraph 337.
19. Section 5(1) deals with rates of tax generally applicable to resident individuals. The currency for Symmetrica is the SY the value of which is assumed to be somewhere in the vicinity of the Euro, the US Dollar, and 100 Yen. The thresholds and rates provided for in section 5(1) are only an example of a typical rate schedule and must be adjusted to local considerations. One point worthy of note is the absence of any exemption threshold. Rather than an exemption threshold, the Sample adopts a personal offset that directly reduces tax payable under this head of income tax, see the discussion below at paragraphs 218 and 219.
20. Section 5(2) and (3) provide an example of a general provision for averaging fluctuating incomes. Loss relief, such as the carry forward under section 33, does not fully address problems with income fluctuating from year to year within bands of taxation. Where two persons have the same amount of income over a five year period, the one whose income fluctuates the most year by year over that period may find they pay more tax than the person with the more stable stream of income. Two industries particularly prone to this problem are the agriculture industry and that of artists and entertainers. However, the issue is not specific to these or any other industries, e.g. it arises with respect to gains recognised on a transactional basis (such as capital gains) and some lump sum retirement payments. This is a general issue under an income tax calculated on a periodic basis.
21. Most countries deal with only part of the income fluctuation problem, e.g. by applying special rates or an averaging mechanism to capital gains. The problem with a piecemeal approach is that it raises characterisation issues, e.g. where persons seek to structure their arrangements so as to take advantage of any relief on offer. Rather than take such an approach, or make no provision at all, the Sample seeks a structural approach to the issue. Section 5(2) and (3) provide a limited averaging of income over a 5-year period subject to certain exclusions from averaging for non-residents and full-time students.

Many countries may feel that this approach is too complicated. Again this is an area where the approach taken should be adjusted to local considerations.

22. As mentioned below at paragraphs 40 and 41, the Sample adopts the individual as the tax subject. This can cause particular problems with income splitting between parents and children. Under section 5(4) the investment income of a resident minor is taxed at the highest individual rate. The relevant income is defined in section 117 and discussed below at paragraph 223. Another approach would be to tax children under the standard rate schedule and place greater reliance on an anti-income splitting rule such as that provided in section 63, discussed below at paragraph 134. Another approach is to adopt the family as the tax subject. Each of these alternate approaches has problems, in terms of perceived equity and administrability.
23. Finally, the treatment of individuals who are resident for only part of a tax year requires comment. Some countries do not recognise parts of tax years with respect to residence and a person is either resident for the whole year or non-resident. This is the approach adopted under the Sample with respect to entities. However, residence for part of a tax year is recognised under the Sample for individuals, see section 109(3) and (4) discussed below at paragraph 211. Where this occurs it is appropriate to reduce the tax rate thresholds that apply to such part-time residents to ensure that they do not benefit from thresholds designed for a full year. This reduction is achieved under section 5(7). The same issue arises in the context of personal offsets and is dealt with in section 115, discussed below at paragraph 219.

## Entities

24. Entities are divided into partnerships, trusts, companies, and foreign branches. A different tax regime is provided under the Sample for each of these types of entities. While the treatment of each type of entity is dealt with in detail in the discussion of Part III, see below at paragraphs 201 to 297, an overview is necessary at this stage. Partnerships and foreign branches are taxed on a look through basis. Their income or loss is calculated on a separate entity basis but the income or loss for a tax year is generally allocated to the partners or branch owner for the year and tax is paid at this level. The exception is domestic branches of non-residents, which are taxed directly as a proxy for the non-resident owner.
25. The treatment of foreign branches as an entity separate from their owners is somewhat unconventional and has a number of important consequences. In particular, it results in recognition of dealings between a foreign branch and, e.g. its head office. These dealings will be subject to the arm's length principle as are dealings between other associated parties. It also means that a foreign branch may be resident in a country different from that in which its owner is resident. This is particularly important for domestic branches of non-residents. As a resident, such a branch will be required to withhold tax from certain payments made by it, including payments made to the branch's owner (subject to double tax treaty requirements). Further, such branches will be

taxable on their world-wide income but entitled to foreign tax relief in the usual manner (including under double tax treaty where this is consistent with the treaty). This treatment will also be relevant where the source of a payment is determined by reference to the residence of the payer.

26. The reason for this treatment of foreign branches is to assimilate them, to the extent possible, with the treatment of subsidiaries. It is also viewed as an appropriate method of securing the tax base (e.g. by applying all anti-abuse rules directly to foreign branches). This treatment also means that only one set of provisions is required for calculating the income of entities situated in one country that are controlled by a resident of another country. That is, no special provisions are incorporated in the Sample for allocating income between a foreign branch and its owner.
27. Trusts are taxed on a semi-look through basis. Their income or loss is calculated on a separate entity basis. However, losses are not allocated to beneficiaries. Income may be allocated to beneficiaries but only in limited circumstances and, in the case of resident trusts, not in any tax year after the year in which the income is derived. Income that is not allocated to a beneficiary is taxed at the trust rate mentioned in section 6(1), which is equal to the highest rate for individuals. This restricts the use of trusts as a tax shelter device. Income tax imposed on a trust under the first head of section 1(1) is calculated in the same manner as for individuals, see the discussion above at paragraph 17. However, personal and medical costs offsets may only be claimed by individuals. Income that is allocated to a beneficiary is taxed at the beneficiary's tax rate.
28. By contrast, companies are taxed on a separate entity basis. Losses and income of companies are not generally allocated to shareholders. Income tax under the first head of section 1(1) is imposed on companies at a rate that is 5 percentage points below the highest rate for individuals. The calculation of tax payable is the same as that for trusts. Dividends distributed by resident companies are subject to a 10 percent final withholding tax under the third head of charge to income tax in section 1(1). The effect is that there may be some benefit in the form of tax deferral for income retained in a company, taxation at 30 percent instead of a potential 35 percent. However, where profits are distributed the overall tax levied with respect to corporate profits is slightly higher than the highest rate for individuals, 37 percent instead of 35 percent. This system represents only a compromise and one form of the many corporate tax systems that may be implemented. It has the advantages of relative simplicity and a small incentive towards saving through companies. The final withholding tax is also likely to be creditable for non-resident shareholders under foreign tax credit systems of foreign countries.
29. The downside of the system is the potential taxation of individuals at rates exceeding their personal marginal rates with respect to income derived through companies, i.e. for individuals otherwise subject to the lower individual marginal rates. This may be true where individuals do not control the distributing company, although in this case there is a question as to who bears the burden of the corporate tax. However, where the company is closely held, the individual controllers will typically be able to engage in

self-help integration by removing what might otherwise be profits in a form that is deductible to the company, such as interest or remuneration. It is unlikely that these sorts of payments would be viewed as excessive where they do not exceed the threshold applicable to the highest individual tax rate.

## **Non-residents**

30. The Sample suggests the taxation of non-resident individuals under the first head of section 1(1) at a flat rate of 20 percent of their taxable income. The type of income in question is likely to be predominantly income from employment. This is because domestic businesses of non-residents will normally create a domestic branch and such branches are treated as separate persons for the purposes of the Sample, see section 105 and the discussion above at paragraphs 24 to 26 and below at paragraph 212. Further, many domestic source payments to non-residents (other than for employment) are subject to final withholding tax under the third head of section 1(1). Like income from employment exercised domestically, these types of payments typically represent domestic wealth created (value added). As mentioned below at paragraphs 141 and 142, domestic wealth created is the primary tax base of the Sample. In order to suppress the incentive for non-residents to characterise payments as of a particular type in order to reduce domestic tax otherwise payable, the Sample seeks to impose a consistent level of tax on payments to non-residents for domestic wealth created. Deductions are essentially denied in calculating income from employment. Therefore, there is a level of equivalence between the taxation of domestic employment income of non-residents at a flat rate under the first head of section 1(1) and the subjection of other domestic source payments to non-residents to final withholding tax at the same rate under the third head.
31. The tax rate selected for non-resident individuals under the Sample is at the low end of the rate schedule applicable to resident individuals. There are a number of reasons for this selection. Non-residents are not granted personal offsets, medical costs offset, or foreign tax offsets and are typically denied many social benefits available only to residents. Further, progression is usually felt inappropriate for non-resident individuals as it is difficult to collect sufficient information to tax them according to their ability to pay, if that were considered appropriate in any case. Further, non-residents may be subject to taxation in their own country of residence. In many cases the thresholds to higher tax rates in the country of residence may be higher than in the country of source. In this case, higher taxation in the source country than in the residence country may have the disadvantage of discouraging highly skilled labour from working in the source country.
32. The second head under which income tax is imposed by section 1(1) is on the repatriated income of domestic branches of non-residents, i.e. a branch profits tax. This tax is imposed in order to provide a treatment similar to the treatment of dividends distributed by resident subsidiaries to non-resident parents. It is possible to produce a similar treatment by treating such branches as resident companies. The present treatment is viewed as more transparent and consistent with common international practice. Branch

profits taxes are, however, inconsistent with Article 10(5) of the OECD Model Tax Convention on Income and on Capital (the "OECD Model") and are often suppressed in double tax treaties.

## **PART II: INCOME TAX BASE**

33. This Part contains rules for calculating taxable income, the tax base that is used in the calculation of income tax payable under the first head of section 1(1). Division I of this Part contains mechanical rules for the calculation of taxable income. Essentially it involves identifying amounts that are included, excluded, or deducted in that calculation. By contrast, Divisions II and III elaborate on amounts identified under Division I. Division II deals with timing the recognition of amounts, quantifying and characterising amounts and allocating them to particular persons. While these issues must be dealt with under any income tax, often they are not well identified or grouped by income taxes in practice.
34. Some amounts included or deducted in calculating income are recognised on a deferred basis. In the case of costs incurred for depreciable assets, the recognition is deferred over the useful life of the asset. In other cases, the recognition may be deferred until an asset or liability is "realised". This type of deferral sets up what is referred to herein as the "transactional basis income tax". This phrase is used in contradistinction to the usual "payments basis income tax" set out in Division I. The distinction is further discussed below at paragraphs 106 to 108 and 157 and 158. The transactional basis income tax is essentially set out in Division III together with the deferred recognition rules for depreciable assets. The latter may have been incorporated within the timing rules in Division II. However, the rules for depreciable assets are heavily integrated with the transactional basis income tax and are incorporated in Division III for convenience. Otherwise, Division III covers the traditional ground of what is referred to in Anglo-Saxon terms as the "capital gains tax". That phrase is not used in the Sample or this Commentary as there is an effort to minimise the distinction between capital and revenue payments.

### **Division I: Calculating the Income Tax Base**

#### ***Subdivision A: Taxable Income***

35. This short Subdivision contains the general formula for calculating the base to which income tax rates are applied in calculating income tax charged under the first head of section 1(1). Section 10 makes it clear that a "slice by slice" (sometimes referred to as a "schedular") approach to the calculation of income is adopted by the Sample. Under this approach a person calculates their income from each employment, business, or investment for a particular tax year. Deductions, if available, are taken separately in each of these calculations of income. This income, after any deductions, is filtered through the jurisdictional rules in section 15 to arrive at the person's assessable income

from each employment, business, or investment for a tax year. These filtered incomes, i.e. the person's assessable income from each employment, business, or investment, are aggregated for a year under section 10. The aggregate is reduced by certain contributions to approved retirement funds under section 191, discussed below at paragraph 310, to arrive at the person's taxable income for the year.

36. There are other ways to calculate taxable income. In particular, a global approach is often used. Under this approach income is not calculated separately for particular activities such as separate employments, businesses, or investments. Rather, inclusions in income from all activities are totalled and amounts deductible are totalled with taxable income equalling any excess of the former over the latter. The primary difference in the approaches is what deductions may be taken against or reduce. Under the global approach, losses from one activity (excess deductions) automatically reduce income (excess inclusions) from other activities. While this may be appropriate in theory and may increase simplicity, it does have some disadvantages.
37. The primary disadvantage of the global approach is a lack of flexibility in targeting potential for abuse. Almost invariably, countries that adopt a global approach end up "schedulersising" the calculation of taxable income by quarantining certain deductions, e.g. those incurred on passive investment (sometimes referred to as "negative gearing"). The difficult theoretical issues that justify quarantining include the blurred distinction between whether a cost is incurred in producing income or whether it represents consumption by a person and is, therefore, not deductible. A simple example is costs incurred in conducting a hobby farm. Another is the difficult issue of determining the timing of deduction for costs incurred in securing lasting assets or benefits. Here there is the potential to "front load" deductions where the real return with respect to which they are incurred will not be derived until an asset is realised in the future.
38. By contrast, countries that adopt the slice by slice approach almost invariably permit losses incurred on one particular slice of activity to offset income on other slices. Therefore, the differing effects of adopting a slice by slice or global approach are often an issue of form and not substance. One disadvantage of the slice by slice approach is that it is necessary to allocate deductions to particular activities. To the extent that a global approach is schedularised, such an approach faces the same issue. The slice by slice approach will vary depending on the types of activity identified for which income must be calculated separately. It is also possible to aggregate the calculation of income from similar activities, e.g. calculate income from all businesses conducted.
39. The slice by slice approach is adopted in the Sample because it is viewed as more transparent and providing greater flexibility for quarantining, particularly deductions. It is also viewed as more intuitive in that persons are more likely to consider whether they have derived income or incurred losses on particular activities before considering whether they have an overall income or loss. This is also likely to be the manner in which accounting records are kept.

40. Taxable income is determined separately for each person. There is no grouping of income between associated persons under the Sample. For example, in the case of natural persons, the individual is adopted as the tax subject. Many countries adopt a broader economic unit as the tax subject, such as a couple or family. A main argument in favour of the broader approach is that it does not discriminate between, e.g. dual income couples and single income couples. However, countries implementing this broader approach often have problems with their tax systems either encouraging or discouraging marriage or other union within an economic unit.
41. By contrast, using the individual as the tax subject discriminates in favour of each member of an economic unit contributing to the unit's income and sharing in its domestic tasks. Where men are the dominant income earners, this may encourage women to enter the workforce and is often viewed as consistent with economic independence of women. Using the individual as the tax subject causes problems with income splitting between members of the same family unit. However, this is also typically true of countries adopting some broader economic unit as the tax subject as there is no obvious line as to when a person is within or outside an economic group. On top of these considerations, many countries may have to factor in the effect of social security or child payments from the government. The tax unit also has important implications for tax administration; generally, the individual unit is simpler. In the result, the Sample opts for using the individual as the tax subject. This approach is another matter that must be adjusted to local considerations and social values.
42. As in the case of individuals, there is no grouping of entities under the Sample in determining the tax subject, e.g. no consolidation is allowed. This approach appears consistent with the slice by slice approach (consolidation appears more consistent with a global approach). Under the slice by slice approach it is possible to provide for the transfer of tax attributes between entities and their associates so as to provide a similar treatment to that available under, e.g. consolidation. This is the approach taken under the Sample. There are three manners in which tax attributes may be transferred between entities and their associates under the Sample. The first is the transfer of losses under section 33, the second is the transfer of assets and liabilities on a non-recognition basis under section 94, and the third is the transfer of excess foreign income tax for purposes of calculating foreign tax offsets under section 200. These transfers recognise that many entities and their associates form but one economic unit and are consistent with a general approach of basing recognition on the substance of activities rather than their form. Each of these provisions and this rationale is discussed further below at paragraphs 93 to 95, 189 to 193, and 316.

### ***Subdivision B: Assessable Income***

43. As mentioned above at paragraph 35, section 15 is the primary jurisdictional filter in the Sample. In the usual manner, world-wide income of residents is assessable whereas only domestic source income of non-residents is assessable. The source of income is a characteristic of income and is determined under section 68, discussed below at

paragraphs 140 to 146. Residence is a characteristic of a person, is dealt with in Part III, and is particularly discussed below at paragraphs 210 to 212.

### *General Formula for Calculating Income*

44. Sections 16, 17, and 18 provide for the calculation of income of a person from an employment, business, or investment for a tax year, respectively. Each section begins with a provision stating that such income is remuneration (employment) or gains and profits (business and investment) from the activity in question. The reference to gains and profits is intended to confirm that the term "income" where used in the Sample is a net concept, i.e. after deductions. This is supported by the definition of "income" in section 345, which is generally in terms of income from employment, business, or investment, and these types of income are defined by reference to sections 16, 17, and 18. While the Sample adopts the general concepts of remuneration and gains and profits to represent income, it then proceeds to be rather specific as to the amounts that must be included and those that may be deducted in calculating income. Specific inclusions are generally provided for by sections 16(2), 17(2), and 18(2) and specific deductions are generally provided for by Subdivision D.
45. The slice by slice approach adopted in the Sample means that income is calculated separately for each activity of a person that constitutes an employment, business, or investment. It is, therefore, necessary to determine the character of a person's activities in order to determine whether they are of these types. The definitions of "employment", "business", and "investment" in section 345 provide the relevant characterisation.
46. "Employment" is the dominant definition and whether an employment exists is primarily determined according to general law (paragraph (a) of the definition). Employment is typically an earning activity consisting predominantly of the provision of labour by an individual. The definition of "employment" is extended, in particular, to include most "managers" of entities, e.g. directors of a company and trustees of a trust, see the definition of the latter term in section 106. The primary reason for this extension is to ensure that these managers are subject to wage withholding. An alternative approach is to treat the activities of these managers as a business and subject payments to them by their entity to withholding as service fees. Under this approach, tax withheld would be adjusted under the tax instalment system. "Employer" and "employee" are defined in terms of "employment" and all of these terms make it clear that only an individual may be the subject of employment.
47. "Business" is defined broadly in section 345 to include trades, professions, vocations, and arrangements with a business character. In this way, the term is used throughout the Sample as a shorthand reference to these types of activities. If a business activity may also be characterised as employment, primacy is given to the characterisation as employment. However, unlike employment, business is an earning activity typically consisting not only of the provision of labour but of the combined provision of labour and capital.

48. It is possible that a particular person conducts more than one business and, therefore, must calculate income separately for each business. There are no rules in the Sample for determining whether a particular person's business activities constitute one or more than one business. This will depend on the facts of each case and local jurisprudence. This matter is not further elaborated in the Sample. As losses from one business of a person may be set against income from another business of the person, the issue will most often not be critical and may be dealt with in practice notes issued by the tax administration. However, the issue will become more acute if a particular country quarantines some or all business losses.
49. "Investment" is also defined broadly in section 345 in terms of holding "depreciable assets" or "investment assets". These types of assets are, in turn, broadly defined in section 76. Essentially, these definitions cover any assets unless they are held primarily for personal use and are not used in the production of gains and profits. The definition of "investment" excludes employment or business. In this way, "investment" is used as the residual manner in which income may be derived and "income from an investment" is the residual category of income. In contrast to employment and business, investment is typically an earning activity consisting predominantly of the provision of capital.
50. As with the definition of "business", the issue arises as to whether certain activities of a person constitute one or more investments. There are two tests adopted for this purpose in the definition of "investment". The first is whether the assets held are of a similar nature. So, for example, a block of shares may constitute a single investment. The second test is whether the assets are used in an integrated fashion, on similar terms, and subject to similar conditions, including as to location. So, for example, a house that is held passively and rented out with associated furniture, will constitute a single investment. Any liabilities incurred with respect to the asset or assets held are also part of the investment.
51. Each of the definitions of "employment", "business", and "investment" is extended to include past, present, or prospective employment, business, or investment, respectively. This extension is intended to ensure that amounts derived and costs incurred with respect to a particular activity either before the activity is started or after it ceases are treated appropriately. For example, where start-up costs are incurred before a business commences, they may be deductible during the tax year in which they are incurred, unless they give rise to a lasting asset in which case Division III will deal with them. This may cause a loss in early years of a business that may be set against income from other businesses or be carried forward under section 33. Another example is where an employee receives remuneration either before or after employment. The remuneration will be included in calculating income from the employment even for tax years before the employment activity commences or after it ceases.

### *Specific Inclusions in Calculating Income*

52. Sections 16(2), 17(2), and 18(2) each provide for specific amounts to be included in calculating income from an employment, business, or investment, respectively. That is, these are amounts that must be included in the calculation of remuneration or gains and profits under section 16(1), 17(1), or 18(1), as the case requires. The relevant lists of inclusions are quite comprehensive but are not intended to be exhaustive. That is, even amounts that are not mentioned must be included if they are required to be included by the ordinary meaning of "remuneration" or "gains and profits".
53. The inclusions in calculating income from an employment for a tax year are couched in terms of payments made to the employee during the year. "Payment" is a central concept of the Sample and is broadly defined in section 41, discussed below at paragraphs 103 and 104. In essence, the definition will cover any financial gain including through in-kind payments. The payments must be made by the employer to the employee. The "making" of a payment is determined by reference to sections 45 and 60, discussed below at paragraphs 111 and 131, respectively. In the case of payments of the type referred to in section 16(2)(a) to (f), no particular nexus is required with the employment. If a payment may be characterised as of one of those particular types then the fact that the payment is made by the employer to the employee is sufficient to require the amount to be included in calculating the employee's income from the employment.
54. By contrast, section 16(2)(g) is of a residual character requiring a more specific nexus, i.e. any other payment made "in respect of" the employment must be included in calculating the employee's income from the employment. This phrase, "in respect of", is a typical nexus test used throughout the Sample. It is not defined and so will take its ordinary meaning. Any further elaboration of this term is only likely to result in further generalities. The tax administration may issue practice notes setting out its view as to when payments, not covered by the prior paragraphs of section 16(2), will meet the nexus in section 16(2)(g).
55. Specific inclusions in calculating income from a business or investment for a tax year are couched in different terms to that used for income from employment. Here the phrase used is "amounts derived". The reason for the difference in terminology is primarily one of timing. Employees are required to account for tax purposes on a cash basis and so payments made to an employee as employee are recognised for tax purposes at the time of payment, see section 46. By contrast, income from business or investment may be accounted for on a cash or accrual basis depending on the type of person involved and the activities of that person. In this case, a payment may be recognised for tax purposes at a time that is different from when the payment is made. "Amount derived" is defined in section 41 in terms of a payment received by a person or which a person is entitled to receive. Which timing is appropriate will depend on the method of tax accounting used by the person.
56. Section 17(2) and 18(2) have some common inclusions in the calculation of income. They include gains on the realisation of assets and liabilities of a business or investment as well as recapture of excess depreciation on the realisation of depreciable assets.

These gains and recapture are calculated under Division III and, as mentioned above at paragraph 34, are essentially net amounts that form the core of the transactional basis income tax.

57. Another common inclusion worthy of specific mention is gifts received in respect of a business or investment. This inclusion in many ways reflects the residual inclusion in calculating income from employment mentioned above at paragraph 54. However, as a payment received in conducting a business or investment may be received as a contribution of capital (generally made out of pre-taxed funds), it is necessary to limit this residual category to "gifts". "Gift" is defined broadly in section 345 as essentially excess consideration received. Gifts from associates are not included in section 17(2) or 18(2) as it will often be difficult to determine if such gifts are made in respect of a business or investment or as a result of the relationship giving rise to the association. Gifts made to entities by associates are generally treated as a contribution to the capital of the entity, see section 165 and the discussion below at paragraph 269. This approach is also consistent with the approach to "income" under the Sample, which does not include mere transfers of wealth, see further below at paragraphs 106 to 108.
58. There are some amounts that are exclusively included in calculating income from a business or investment under sections 17(2) and 18(2). "Service fees" are included in calculating income from a business under section 17(2) as are "incomings" for "trading stock". The first of these terms is defined in section 345 in terms of a payment attributable to the rendering of services by a business. As an investment activity will not involve the provision of labour, this head of inclusion is not reflected in section 18(2). Similarly, "trading stock" is defined in section 76 in terms of assets sold in the ordinary course of conducting a business. "Incomings" is a central concept in the transactional basis income tax and will include all amounts received in respect of assets such as trading stock, see section 81 and the discussion below at paragraphs 165 and 166. This means that sale proceeds from trading stock are directly included in calculating income. This is in contrast to amounts derived from the realisation of other assets of a business where only the net gain on the realisation is so included. In order to balance this situation, a person may deduct an allowance for trading stock under section 28, which essentially represents the cost of trading stock sold. The result on the realisation of trading stock is essentially consistent with that on the realisation of other business assets under the transactional basis income tax.
59. Another important inclusion in calculating income from a business is provided by section 17(2)(g). An amount of the type referred to in section 18(2), i.e. included in the calculation of income from an investment, that is effectively connected with a business is included in calculating income from the business and not income from an investment. The phrase "effectively connected" is not defined and again is an issue of nexus. This phrase is often used in double tax treaties and is intended to have the same meaning as in such treaties. The primary operation of section 17(2)(g) is with respect to amounts referred to in section 18(2)(a). This head of inclusion in calculating income from an investment is not otherwise reflected in section 17(2) in calculating income from a business.

60. Section 18(2)(a) makes reference to the classic forms of return on capital being "dividend", "interest", "natural resource payment", "rent", and "royalty". Gains from "investment insurance" and "an unapproved retirement interest" as well as "retirement payments" are also referred to and are further discussed below, see paragraphs 305, 309, and 310. Each of these terms is defined in or via section 345. "Dividend" is defined broadly and is essentially any return of a shareholder from an interest in a company. "Interest" is defined in terms of a payment for the use of money. This definition includes certain payments under debt obligations and other financial instruments as well as amounts payable under an annuity, instalment sale, or finance lease that are characterised as interest by section 67.
61. "Natural resource payment" is defined as payment for a right to take natural resources. Natural resource payments are treated in the same manner as rents and royalties under the Sample. The definitions of "rent" and "royalties" exclude natural resource payments. "Rent" is defined in terms of a payment under a lease of a tangible asset and "royalty" in terms of a payment under a lease of an intangible asset with a list of specific inclusions. "Lease" is also defined in section 345 in terms of a temporary right in respect of an asset of another person, other than money. Accordingly, the broad approach under the Sample is that payments for the use of money are interest, payments for the use of tangible assets are rents, and payments for the use of intangible assets are royalties. The reason for the separate identification of natural resource payments is that in most cases these payments are not for the use of an asset but, rather, the removal of assets forming part of the land. Further, these payments often give rise to greater source country rights to taxation under double tax treaties.

### *Specific Exclusions in Calculating Income*

62. Sections 16(3), 17(3), and 18(3) provide for the exclusion of certain amounts in calculating income from an employment, business, or investment, respectively. Commonly excluded by these provisions are "exempt amounts" and "final withholding payments". Both of these phrases are defined in or via section 345. Exempt amounts are excluded because they either represent taxed funds or are exempt on other policy grounds. Final withholding payments are excluded because withholding of tax from these payments represents a final income tax liability under the third head of charge in section 1(1).
63. Certain other amounts excluded in calculating income by section 16(3), 17(3), or 18(3) are not reflected by exclusions in the other sections. The exclusive exclusions under section 16(3) are relatively self-explanatory. The exclusive exclusion under section 17(3) is intended to give primacy to inclusion in calculating income from an employment and that in section 18(3) to give primacy to inclusion in calculating income from an employment or business.

### ***Subdivision C: Exempt Amounts***

64. Section 20 is the primary exemption provision in the Sample. Exemptions are kept to a minimum and there are no particular industry concessions. Conventional wisdom suggests that these types of concessions often cause more harm than good. Most of the exemptions in section 20 are self-explanatory but a couple require some further elaboration.
65. Section 20(1)(f) and (g) are related and can be dealt with together. The Sample incorporates a relatively comprehensive income tax. While some academically supported comprehensive definitions of income suggest that gifts should be included, in practice countries predominantly do not tax gifts as income, except in limited circumstances. Gifts are often taxed in practice under a gift, wealth, or inheritance tax. The reasoning is that the income tax is targeted at wealth creation (value added) and not the simple holding or transfer of assets, see further paragraphs 106 to 108. Consistent with this theme, it is possible to include gifts in calculating income of the donee if a tax deduction is granted to the donor. This approach seems to add unnecessary complexity to an income tax and open up opportunities for income splitting.
66. Accordingly, the Sample exempts gifts (including on death) unless they are derived in the course of an earning activity, see section 20(1)(f). Gifts from non-associated persons are included in calculating income where derived in the course of an earning activity because it is difficult to distinguish such gifts from the return from the activity in question. Further, while gifts are generally not included in calculating income of the donee, where the gift is of an asset, the donor will realise the asset. Typically, the donor will be treated as deriving an amount from the realisation equal to the market value of the asset, see section 94. This means that the donor may be treated as deriving a gain from realisation or, in limited circumstances, a loss. Such a gain or loss may be included or deducted in calculating the donor's income, i.e. as a result of the transactional basis income tax, where the relevant asset is held as part of a business or investment.
67. Also exempted are amounts derived in respect of assets and liabilities held for personal purposes that are not used in the production of gains and profits. Such amounts would not be included in calculating income under Subdivision B in any case and so section 20(1)(g) is mainly by way of confirmation. This exemption is necessary for administrative purposes, e.g. people are unlikely to retain records of the assets in question.
68. Section 20(1)(h) exempts amounts derived by exempt organisations. The exemption does not extend to amounts derived in conducting a business that is unrelated to the organisation's exempt status. This limitation is needed in order to ensure that exempt organisations do not compete in markets where they have a tax advantage over other market participants. This would distort competition in the market. "Exempt organisation" is defined in section 20(2). The types of organisations exempted must be adjusted to local social values and the inclusions in the Sample are only by way of example. The Sample grants the exempt status only where the organisation has obtained

a private ruling confirming its status and meets the requirements against providing collateral benefits outlined in section 20(2)(c).

### ***Subdivision D: Deductions***

69. This Subdivision contains rules regarding the deductibility of amounts in calculating a person's income. It begins with a general deduction provision and the rest of the Subdivision proceeds to deal with some particular issues that might not be appropriately dealt with by the general provision. As a general rule, no deductions are available in calculating income from employment. This is because section 25(1) prohibits deductions unless expressly allowed and none of the primary deduction provisions allow deductions in calculating income from employment. This approach is adopted for two reasons. Firstly, payments for work performed in the course of employment usually represent pure payments for the provision of labour and this is a form of wealth created (value added). By contrast, many payments in the course of conducting a business or investment represent payments for the transfer of wealth and not wealth created through the provision of capital. Therefore, deductions are primarily available in calculating income from a business or investment to ensure that transfers of wealth are not taxed. This reasoning does not apply in the case of income from employment. Secondly, as mentioned above at paragraph 18, a lack of deductions in calculating income from employment means that in many cases the wage withholding tax may serve as a final tax.

#### *General Deduction Provision*

70. Section 25 is divided into two main parts, the first is a provision denying deductions and the second is a provision allowing deductions. Section 25(1) overrides all other provisions of the Sample in providing that certain amounts are not deductible. The broad residual category is that no deduction is allowed unless expressly provided for by the Sample. The effect of this is to override any deduction that might otherwise be available by reason of the general formula of income from an employment, business, or investment being based on remuneration or gains and profits, as the case requires. "Consumption costs" and "excluded costs" are not deductible in any case, even if the costs would otherwise be treated as deductible by another provision. These terms are defined in section 25(4).

71. As the name suggests, "consumption costs" are essentially costs that are considered to represent consumption by an individual and, therefore, that should not reduce income. The classic examples of these costs are set out in paragraph (a) of the definition, i.e. costs with respect to shelter, food, leisure, commuting, clothing, and education. A clear distinction between costs that represent personal consumption and those that are incurred in deriving income is difficult, if not impossible, to make or apportion. Again the Sample takes the approach of outlining some general principles that must be adapted

to particular circumstances and may appropriately be the subject of practice notes issued by the tax administration.

72. Paragraph (a) of the definition of "consumption costs" deals with costs incurred by individuals in respect of themselves whereas paragraph (b) deals with costs incurred by another person in respect of an individual. In the case of paragraph (b) the provision of shelter, food, leisure, commuting, clothing, or education by a person to an individual will constitute a payment by the person to the individual, see the definition of "payment" in section 41(1). The issue becomes whether the person may claim a deduction for costs incurred in making the payment to the individual. No deduction will be allowed for such costs unless one of the conditions of paragraph (b)(i), (ii), or (iii) of the definition are met.
73. The first of these conditions is that the payment is included in calculating the individual's income. Whether or not the payment is included in calculating the individual's income will depend on whether the payment is sufficiently connected with an earning activity of the individual for the purposes of sections 16, 17, and 18. For example, assume that an employer provides an employee with a payment in the form of a fringe benefit. If the fringe benefit is not included in calculating the employee's income, e.g. the provision of in-house meals and refreshments referred to in section 16(3)(b), generally no deduction will be allowed to the employer for costs incurred in making the payment, e.g. the costs of the food and any help in serving the meals. In other words, the costs incurred by the employer in making the provision to the employee represent consumption by the employee. If the payment is included in calculating the employee's income then whether or not a deduction is available for costs incurred by the employer in making the payment depends on whether the costs are deductible under another provision such as section 25(2).
74. The second condition that excludes costs incurred in making a payment to an individual from the definition of "consumption costs" is where the individual provides market value consideration for the payment. So, for example, costs incurred in providing a meal at a restaurant will be deductible by the restaurant owner if individuals to whom meals are provided pay for them. Costs incurred in providing free meals to relatives would not be deductible. This rule should not deny a deduction for costs incurred in providing samples or prizes to individuals. In this case, by providing their services in sampling or entering a competition, individuals may be considered to have provided market value consideration through the provision of their services. Such costs may also not be consumption costs by reason of paragraph (b)(iii) of the definition of "consumption costs", which is relatively self-explanatory.
75. Deduction of "excluded costs" is also prohibited. This term includes costs incurred in paying certain bribes, fines, and penalties. The policy here is to ensure that the effective cost of bribes, fines, and penalties to the payer is not reduced by reason of deductibility. "Excluded costs" also include those incurred in deriving exempt amounts and those incurred by non-residents in deriving final withholding payments. In the latter case, this is consistent with these payments being subject to a final withholding tax on the gross

amount of the payment. Costs incurred by residents in deriving final withholding payments are not "excluded costs" and so deductions may be available for such costs. The only types of final withholding payments that may be made to residents are dividends, gains from investment insurance, and gains from unapproved retirement interests paid by resident entities. In all these cases the final withholding tax represents a second layer of tax on top of any tax levied on the distributing entity's income, see the discussion above at paragraphs 28 and 29. If a deduction were denied for costs paid in deriving this income, the inclusion of the costs in calculating the income of the recipient of the costs and the taxation of this income might produce a third layer of tax with respect to the same wealth created. This would be inconsistent with the theme of the Sample.

76. Section 25(2) is the general provision allowing deductions in calculating income from a business or investment for costs incurred in the production of the income. "Costs incurred" is defined in section 41 in terms of making a payment or being obliged to make a payment. In a similar fashion to the deriving of an amount, when a person incurs a cost will depend on the method of tax accounting being used by the person, see section 46. The words "to the extent" in section 25(2) provide for apportionment of costs that are only partly incurred in the production of income. This phrase, or a similar phrase, is used throughout the Sample where apportionment is available. Section 25(3) proceeds to deny a deduction for certain costs. However, section 25(2) and (3) are subject to the other express deduction provisions in the Sample. Further, section 25(2) is expressly subject to section 25(3). Therefore, a deduction that may be allowed by section 25(2) may be denied by another provision, including section 25(3). A deduction that may be denied by section 25(3) may be allowed by another provision, but not including section 25(2).
77. Under section 25(3) a deduction is denied for costs of a capital nature. This reflects an Anglo-Saxon approach to income taxation. However, the definition of "costs of a capital nature" in section 25(4) does not bear out the traditional capital/revenue distinction. In particular, costs incurred in acquiring an asset are of a capital nature where the useful life of the asset exceeds 12 months. The resultant non-deductibility of such costs is ameliorated in two ways. With respect to costs incurred by a business or investment in purchasing a wasting asset, the costs are effectively deductible over the useful life of the asset by reason of the allowance for depreciation under section 31. Secondly, if the asset is non-wasting, the costs are effectively deductible when the asset is realised under the transactional basis income tax, i.e. in calculating any gain or loss from the realisation of the asset under Division III.
78. Under section 25(3)(d) a deduction is denied for costs incurred on the realisation of a liability. Again however, these costs will be effectively deductible in calculating any gain or loss on the realisation, assuming the liability is owed by a business or investment. Under section 25(3)(e) foreign income tax is not deductible. This is because foreign tax offsets are provided under section 200. Under section 200(5), a person may relinquish a foreign tax offset in favour of a deduction. In this case, a

deduction is not denied by section 25(3) because that section is expressly subject to Part IV, which contains section 200(5).

### *Specific Deduction Provisions*

79. Sections 26 to 33 in a sense override section 25(2) and (3) by either granting a deduction that would be denied by the general deduction provision or denying a deduction otherwise deductible under that provision. Section 26 is different from sections 27 to 33 in that it plugs into section 25(2). Its intention is to treat interest paid on funds borrowed as incurred in the production of income where the funds are used in that production or used to acquire an asset used in that production. Section 26 looks to the use to which the borrowed funds are put and not the purpose for which the funds were borrowed. This means that where the use of the funds changes so may the deductibility of interest incurred with respect to the funds.
80. Section 27 requires some explanation. It is intended to address the tax base erosion problem towards which thin capitalisation and similar provisions are directed. This erosion results from controllers of an entity being able to remove funds from the entity in a deductible form that is subject to less taxation than if the funds were removed from the entity in the form of a distribution of profits. While this is a general tax design issue and relates to the inherent fungibility of different types of payments, it is typically of greatest concern with respect to non-resident controllers of resident entities. The typical provisions adopted in this area, such as thin capitalisation rules, are either very complicated, very arbitrary, or both. There appears no justification for repeating this style of provision in a Sample income tax.
81. The tax base in issue is typically the source tax base and raises a classic issue for source countries, particularly developing countries. The issue is the amount of tax that may be levied on the basis of source without deterring foreign investment. There are at least two source tax bases that may not result in such deterrence. The first is tax for which foreign tax relief is available in the capital exporting country. As capital exporting countries adopt many different methods of foreign tax relief this tax base is problematic, particularly the complexity it involves for developing countries. The most likely tax that will be granted foreign tax relief by capital exporting countries is a relatively low rate direct tax. The Sample seeks to access this tax base by imposing a consistent 20 percent final withholding tax on potentially deductible payments by resident entities to non-residents that essentially represent domestic wealth created. This tax may not always hit the mark in securing foreign tax relief in a capital exporting country, e.g. where the foreign investor is tax exempt in that country. It may also be sacrificed to some extent in negotiating double tax treaties. Again, the level of this withholding tax must be adjusted to local considerations.
82. In principle, the second relatively secure tax base available to source countries is economic rents derived by non-residents from the source country. The taxation of economic rents may not deter foreign investment as the source country is only taxing the

amount above what can generally be secured elsewhere. Indeed, there seems strong justification for taxing abnormal returns derived by non-residents, which at some level represent exploitation of the source country's markets and resources. The primary benefits from these markets and resources should go to the local society.

83. Section 27 is a relatively simple rule directed towards securing this second tax base. As with other provisions of the Sample, it is just one example of an approach to address a particular problem and must be adjusted to local considerations. It places a cap on the total amount of deductions that a person can claim for certain payments that are subject to final withholding tax, referred to as "investment final withholding payments". This phrase is defined in section 222 to cover payments of interest, natural resource payments, rents, and royalties to non-residents. It may also include payments of wages or service fees to a non-resident that is associated with the payer. A deduction may be claimed for these types of payments cumulatively during the year until the relevant threshold is reached, at which stage a deduction is denied for any further payments of these types.
84. The threshold is calculated by reference to the formula in section 27(1). In order to identify economic rents it is necessary to deduct a standard rate of return. The standard rate identified in the Sample is the statutory interest rate, i.e. the general rate applied throughout the Sample to calculate things like interest on outstanding tax. It is viewed as in the low range and particular countries may use a higher rate. The rate is applied to the "gross domestic value" of the business or investment at the start of the year or an average value over the year may be used on notice by the tax administration, e.g. in cases of suspected abuse. This value is defined in section 27(2) by reference to the book value of assets, determined gross of liabilities and according to generally accepted accounting principles.
85. As in the case of other thin capitalisation type rules, the rule in section 27 raises issues as to whether it is permitted by international norms. One issue is whether it is contrary to Article 24(4) of the OECD Model. This provision requires "interest, royalties and other disbursements" by a resident of one country to a resident of the treaty partner to be deductible "under the same conditions" as if paid to a resident of the one country. It is arguable that, in the context of section 27, a payment to a resident that is not subject to final withholding tax and one to a non-resident that is subject to final withholding tax are not paid "under the same conditions". In order to enable non-residents to put themselves under the same conditions as residents, section 222(3) enables non-residents to elect that a payment that would otherwise be a final withholding payment is not a final withholding payment. In this case, the non-resident would be taxed by assessment. Therefore, it appears section 27 does not breach Article 24(4). In any case, Article 24(4) is subject to Article 17(1), which may secure the operation of Section 27 in the context of payments to foreign associated persons, the predominant situation in which it is likely to apply. Further, Article 24(4) is often suppressed in double tax treaties.
86. Another issue is whether income tax levied as a result of the denial of a deduction under section 27 is available for foreign tax relief in capital exporting countries. While this

issue must be investigated on a country-by-country basis, it does seem that the denial of this deduction, just like that under more conventional thin capitalisation rules, would not change the nature of the tax. In any case, even if a particular capital exporting country denied foreign tax relief for this tax, it may be that the foreign investor could engage in self-help. The threshold is only likely to be breached with respect to payments made to a foreign associate of the resident entity. In this case, it would appear appropriate for the resident entity to change the nature of the relevant payments to distributions of profits to the foreign associate. As a distribution of profits, the payments will not be deductible and will be subject to a final withholding tax or branch profits tax. In essence, the excessive payments will be subject to the same tax treatment by the source country irrespective of whether they take the form of a non-deductible payment under section 27 or a distribution of profits. Where characterised as a distribution of profits, the tax underlying the distribution (representing a denial of a deduction for the payment) should be granted foreign tax relief by capital exporting countries.

87. Section 28, dealing with trading stock, is more straightforward. The terminology used in this section is heavily integrated with Division III dealing with assets and liabilities. Essentially, section 28 grants a deductible allowance for the cost of trading stock disposed of during a tax year but otherwise denies a deduction for the cost of trading stock. The combined effect of this section and section 17(2)(b), which includes amounts derived in respect of trading stock directly in calculating income, is consistent with that under the transactional basis income tax with respect to other assets under Division III. The issue of identifying the cost of trading stock at the end of a tax year and, thereby, the cost of trading stock disposed of during the year is determined under section 80 and discussed further below, see paragraphs 163 and 164.
88. The approach to repair and improvement costs in section 29 requires some explanation. Many income taxes grant an immediate deduction for costs incurred in repairing depreciable assets but require depreciation of costs incurred in improving depreciable assets. However, the distinction between a repair and an improvement is notoriously difficult to determine. Section 29 ignores this distinction by granting a limited deduction for costs incurred in the repair or improvement of depreciable assets. The deduction available with respect to all assets in a particular pool of depreciable assets is limited to 5 percent of the written down value of the pool at the end of the tax year in question. Any cost that is not deductible is added to the depreciation basis of the pool and will be depreciated. Pools of depreciable assets are discussed below at paragraphs 175 to 183.
89. Section 30 provides a deduction for certain research and development costs. In the absence of section 30, these costs might not be deductible under section 25(2), e.g. because they are of a capital nature or not incurred in producing income. This provision does not grant an immediate deduction for costs that are incurred in the acquisition or improvement of an asset. Such costs are dealt with under the general provisions applicable to costs of that type. Section 30 only grants a deduction for research and development costs that are not directly connected with an asset.

90. Depreciation allowances are deductible under Section 31 and are discussed below in the context of Subdivision B of Division III at paragraphs 175 to 183.
91. Section 32 deals with the deductibility of losses on the realisation of business and investment assets and liabilities. It is the counterpart of sections 17(2)(c) and 18(2)(b), which include gains on such a realisation in calculating income from a business or investment. Under section 32(1), losses on the realisation of business assets and liabilities are essentially fully deductible. This treatment is more in keeping with a Continental European approach to income tax than an Anglo-Saxon approach under which capital losses are generally quarantined and only permitted to be deducted against capital gains. Losses on the realisation of investment assets and liabilities are treated in the same manner.
92. Section 33(1) is the primary provision that controls the use of losses from one earning activity to reduce income from another earning activity. The general approach is that any loss from a business for a tax year may reduce any other income from a different business or investment for the same year but not income from an employment. Any excess business loss may be carried forward to reduce income from any business or investment of a future tax year, i.e. unlimited carry-forward. Section 33(2) essentially provides for the quarantining of certain losses. Losses from an investment are treated in the same manner as losses from a business except that they may only reduce income from an investment. Further, foreign losses sourced in a particular country may only reduce foreign income sourced in the same country. The source of income or a loss is determined in accordance with section 68, discussed below at paragraphs 140 to 146. These two quarantining rules are cumulative. The reason for this approach to quarantining was discussed above at paragraphs 35 to 39 and its content should be adjusted to local considerations.
93. Section 33(1)(c) specifically allows a person to use, by way of transfer, an unrelieved loss of an associate where the requirements in section 33(3) are met. A transferred loss does not become a loss of the transferee and once transferred is no longer an “unrelieved loss” of the associate transferor, see the definition of that phrase in section 33(8). The requirements in section 33(3) need further explanation. Firstly, one of the parties to the transfer must be an entity and neither a partnership. The transfer of losses to or from an entity enables the transfer of tax attributes. The reasons for permitting this were discussed above at paragraph 42. Secondly, the transferor and the transferee must be residents from the time the loss is incurred until it is transferred. This requirement seeks to protect the tax administration against bogus claims where the administration may have difficulty in substantiating a transfer claim. Where substantiation is not an issue, e.g. where there is good exchange of information under a double tax treaty, this requirement may be relaxed.
94. Section 33(3) also requires common underlying ownership of at least 50 percent between the transferor and the transferee of a loss. The justification for transfer where there is 100 percent common underlying ownership is strong, i.e. the difference of identity between the transferor and the transferee is only a matter of form and not

economic substance. Where the required level of common underlying ownership is less, there is potential for tax arbitrage. This level is also discussed below in the context of the non-recognition treatment of transfers of assets and liabilities under section 94, see paragraph 192. Section 94 may permit the transfer of unrealised losses on assets and liabilities between associates. It is, therefore, important that the requirements for transfer of realised losses under section 33(1)(c) are similar to those for the transfer of unrealised losses under section 94. The level of common underlying ownership required by section 33(3)(b)(ii) is relatively low. This level and the general availability of transfer of tax attributes under rules such as those in sections 33(1)(c) and 94 should be adjusted to local considerations. However, where one or both of these rules are adopted, broad value shifting rules such as those in sections 173 and 174 are of added importance. These are the primary rules that seek to prevent tax arbitrage through the use of sections 33(1)(c) and 94.

95. Under section 33(3)(c), a loss may only be transferred to the extent that it can be used immediately by the transferee. Therefore, a loss cannot be transferred such that it is available for carry-forward by the transferee under section 33. If this were otherwise, the common underlying ownership rule would have to be extended to the time at which the transferee uses the loss. Finally, section 33(3)(d) requires a written transfer. Further, for reasons of administrative certainty, the transfer must occur by the time for filing the relevant return of income.
96. Section 33(4) and (5) specifically pertain to losses incurred under long-term contracts and are further discussed below at paragraph 125. Section 33(6) is a specific anti-avoidance rule. Generally, non-residents are not required to withhold tax from payments with a domestic source under Subdivision A of Division II of Part V. However, under section 213 non-residents may elect to bring themselves within the withholding obligations for a tax year. Where those withholding obligations are complied with then, as mentioned above at paragraph 85, the non-resident may further elect that what would otherwise be final withholding payments derived by the non-resident during the year are not final withholding payments. This election would entitle the non-resident to claim deductions and be taxed by assessment instead of final withholding tax. Section 33(6) is designed to prevent non-residents abusing these elections by, e.g. incurring domestic source deductions in election years and not making elections in years in which domestic source amounts are derived.

## **Division II: Rules Governing Amounts Used in Calculating the Income Tax Base**

97. As mentioned at paragraph 33, this Division deals with issues of timing the recognition of amounts used in calculating the income tax base, quantifying and characterising these amounts, and allocating them to particular persons. It begins with a subdivision devoted to some concepts that are important for the entire Sample but that are particularly central to the rules contained in the following subdivisions.

## ***Subdivision A: Central Concepts***

98. The first central concept dealt with in this Subdivision is the period by reference to which income tax is calculated. This period is referred to as the "tax year". The simplest approach to identifying this period is to require all persons to use the same tax year. However, this approach is inflexible and some persons have legitimate reasons for requesting the use of a non-standard tax year. The typical reason of most substance involves an entity that is part of an international group where the tax accounting of the group may be performed more accurately and efficiently if it is performed according to a common period. Nevertheless, permitting persons to adopt a non-standard tax year adds to the complexity of an income tax and has the potential to open opportunities for tax reduction or deferral. Again, whether this type of permission should be available must be determined according to local considerations.
99. Section 40 provides a relatively simple example of permitting certain persons to adopt a non-standard tax year. The general rule is that all persons must use the calendar year as their tax year. The tax administration is empowered to approve an application to substitute this tax year in particular cases. This power is broad and may be subject to conditions. Further, the permission may be revoked by the tax administration and there are no express prerequisite conditions as to when the power of revocation may be used. The reason for limiting the use of non-standard tax years in this manner is, as mentioned above in the last paragraph, the potential for tax reduction or deferral. Tax reduction may be an issue where tax rates change, particularly if the change takes effect from the start of a tax year, e.g. tax years beginning after the change. One manner to address the problem of tax rate changes and non-standard tax years is to ensure that the change takes effect from a particular date. Where this date falls within the middle of a tax year of a particular person, the person could be required to calculate their income separately for the part of the year falling before the change and the part after the change. Alternately, income for the entire year may be apportioned according to the part of the year falling before and after the change. Neither option is ideal as the first increases compliance costs and the second may prove somewhat arbitrary.
100. Tax deferral through the use of non-standard tax years may be direct or indirect. Deferral will be direct if the tax payment procedure is fixed by reference to the standard tax year. For example, the tax instalment system and return and assessment procedures will not apply appropriately to persons using a non-standard tax year if they are timed for the standard tax year. For this reason it is essential that, if non-standard tax years are permitted, the tax payment procedure is timed differently for each person depending on their particular tax year. This means that different persons will have different dates for making instalment payments, filing returns, and making final tax payments. This is the approach taken in the Sample. However, this approach does raise tax administration issues. On the one hand, this approach may create difficulties for the tax administration in auditing compliance. On the other hand, it also has the potential to enable the tax administration to spread its workload over the standard tax year. Again, this is an issue for local consideration. However, if the view is taken that the tax payment procedure

must run according to a uniform timetable, it is better if non-standard tax years are not permitted.

101. Tax deferral may be indirect where an entity is taxed on a pass through basis and the entity and its owners have different tax years. This is the treatment of partnerships, resident's foreign branches, and potentially trusts under the Sample. All entities are required to calculate their income separately from their owners. If the entity's income (or loss) is only allocated at the end of the entity's tax year, the usual approach, and its owners have a tax year ending after that of the entity, there is the potential for tax deferral. This potential deferral may be largely addressed by requiring the entity to pay instalments of tax during its tax year. This is the approach adopted under the Sample with trusts.
102. By contrast, in the case of partnerships and resident's foreign branches, the Sample requires the partners or the owner to pay tax rather than the entity. The potential for deferral is addressed in the case of resident's foreign branches by requiring the branch to have the same tax year as its owner. This option is not possible in the case of partnerships because the partners themselves may have different tax years. It would be possible to require partnerships to pay instalments of tax in the same manner as trusts. However, given the potentially small size of partnerships and that the income of individual partners may be taxed at the lower end of the individual tax rate scale, this option is not ideal. It would also be possible to only require certain partnerships to pay instalments, e.g. partnerships other than those where the partnership and all partners have the same tax year. This would create greater complexity. The Sample does not directly address this issue of potential tax deferral in the case of partnerships other than through general powers given to the tax administration including the power to revoke the use of a non-standard tax year.
103. Section 41 includes definitions of three terms that in many ways form the backbone of the Sample. These terms have been discussed in part above at paragraphs 53, 55, and 76. The key building blocks to the income tax base are payments, whether they are made, obliged to be made, received, or entitled to be received. "Payment" is defined in section 41(1) and is intended to reflect all manners in which a financial benefit or satisfaction may be directly conferred on a person and should cover all forms of fringe benefits. It is, therefore, broader than the conventional meaning of the term "payment" and, perhaps, closer to conferring wealth on another person.
104. The definition of "payment" has a number of heads the first of which requires a direct reduction of the payer's assets or increase of the payer's liabilities by way of transfer. The second head of payment involves the creation of assets in the payee, e.g. the granting of a lease or option. It also covers the decrease of liabilities of the payee, e.g. the forgiveness of a debt or release of a guarantee, lease, or option. The third head of payment involves the provision of services and the fourth the use or availability for use of an asset owned by another. This means, e.g. that the provision by an employer of a driver, gardener, or the use of a car to an employee will constitute a payment to the employee. As these forms of payment may be continuous over a period of time, section

41(2) contains rules to divide these payments so that the payer and payee may appropriately account for them with respect to particular tax years.

105. As mentioned above at paragraphs 55 and 76, the phrases "amount derived" and "cost incurred" are variations of the concept of payment that focus on tax accounting under the Sample. That is, the timing of when an amount is derived or a cost is incurred depends on whether the person in question accounts on a cash or accrual basis. In particular, a person may derive an amount on an accrual basis where the person is entitled to the amount or incur a cost where the person is obliged to make a payment provided the other requirements of section 48(2) and (3) are met. This is why the definitions of "amount derived" and "cost incurred" incorporate references to entitlement to a payment and an obligation to make a payment, respectively.
106. The definition of "cost incurred" requires some further comment. It is limited to "payments" under the first head of that term, i.e. those involving a transfer causing a direct reduction of the payer's assets or increase of the payer's liabilities. As mentioned above at paragraph 65, in principle an income tax is targeted at creation of wealth or value added and not transfers of assets. Arguably, wealth is constituted by anything that a person is willing to pay for, i.e. has the potential to provide human satisfactions. An asset is like a store of future human satisfactions. On this view, the primary forms of wealth creation (the creation of human satisfactions or value added) are through human labour and the use of assets. Transfer of an asset is not a creation of wealth. Wealth of a person may also be created through an increase in the value of the person's assets but equally it may be lost through a decrease in value of those assets. Any net increase in the value of all assets of a country (capital gains) will typically form a small part of an income tax base by comparison to creations of wealth through human labour and the use of assets. Most increases in the value of assets that are recognised under an income tax only represent a relative change in prices that are offset by decreases in the value of other assets.
107. The distinction between earning activities and leisure (or consumption) means that wealth creation is typically only recognised under an income tax where it occurs in the course of an earning activity. Further, the realisations criterion means that creations of wealth (value added) are only recognised where they are paid for by a person other than the person creating the wealth or holding the asset creating the wealth. Assume a market scenario in which all payments to and by a person are balanced by a return payment by or to the person of an equal value. In this case, the value of a payment to a person for wealth created will equal the value of the wealth. Further, all wealth obtained (payments received) by a person less divestitures of assets by the person should approximate wealth created by the person. Therefore, a simple definition of the "payments" income tax base, which is typically the primary income tax base, of a person for a particular time period involves-

- (i) all wealth obtained (payments derived) by the person during the period in conducting an earning activity, less

- (ii) all assets divested of the person during the period in conducting an earning activity.
108. The first limb of the definition conforms to the basic approach under the Sample of including in calculating income all payments derived in the course of an earning activity. In order to approximate just wealth created by the person assets divested of the person are deducted under the second limb. It is towards this end that costs incurred in conducting a business or investment are deductible. It also means that the definition of "costs incurred" is limited to "payments" under the first head of that term, i.e. those involving transfer causing a direct reduction of the payer's assets or increase of the payer's liabilities. Head three and four payments made by the person represent the creation of wealth, i.e. the primary base towards which the income tax is targeted, and a deduction is not appropriate. Head two payments made by a person do not represent a divestiture by the person and so do not meet the realisations criterion, even if they result in a reduction in value of the person's net assets. Of course, these basic rules in the Sample are supplemented by many complex rules to account for liabilities, capital gains, timing issues, and the market value and arm's length principles.
109. Section 41(5) contains what is commonly referred to as the claim of right doctrine. It is essentially an elaboration of when a person is considered entitled to or obliged to make a payment. As mentioned above at paragraph 105, this is important for determining when an amount is derived or a cost is incurred where the person in question is accounting on an accrual basis. A person is treated as entitled to receive or obliged to make a payment if the person claims to be legally so entitled or obliged, even if the person is under a misconception.
110. Section 42 causes the rules in Division II to apply to amounts recognised on a transactional basis under Division III. As mentioned previously at paragraph 34, under an Anglo-Saxon approach "capital" payments are not directly recognised under the income tax but, rather, are used in calculating gains and losses on the realisation of assets and liabilities, i.e. they are recognised under the transactional basis income tax. In essence the issue is one of event giving rise to recognition, i.e. a payment or the completion of a transaction (realisation of an asset or liability). Therefore, it seems appropriate that the same timing, quantification, allocation, and characterisation rules apply to all amounts used in calculating income irrespective of whether their recognition is directly on a payments basis or indirectly on a transactional basis.

### ***Subdivision B: Timing of Amounts***

111. This Subdivision contains the central timing provisions in the Sample. It begins in section 45 by outlining the time at which the central concept of a payment is made and received. This timing is determined by reference to the activity giving rise to the payment. Importantly, the timing of a payment is not affected by tax accounting rules, i.e. whether a person is accounting on a cash or accrual basis. By contrast, section 46 deals with when an amount is derived or a cost is incurred and, as mentioned above at paragraph 105, this is affected by the method of tax accounting used. The Sample is

particular throughout in the use of these concepts of payments made and received, amounts derived, and costs incurred. For example, inclusions and deductions in calculating income from a business or investment use the concepts amounts derived and costs incurred and so tax accounting is important. By contrast, the obligations to withhold tax from certain payments under Division II of Part V use the concept of payment made and so the tax accounting method of the payer is irrelevant.

112. Section 46 recognises the cash and accrual methods of tax accounting. It specifies use of these methods along conventional lines, e.g. the cash method is to be used by employees and the accrual method by companies. Otherwise and subject to adjustment by the tax administration, a person may choose their method of tax accounting. A person should use the method that best reflects the person's gains and profits. Which method is most appropriate for a particular person will depend on the person's circumstances and this is another area in which it may be appropriate for the tax administration to issue practice notes.
113. Sections 47 and 48 outline the content of the cash and accrual methods. The timing of amounts derived and costs incurred under the cash method is primarily aligned with the timing of the underlying payment. By contrast, under the accrual method the timing of amounts derived and costs incurred is typically an issue of entitlement to the underlying payment or an obligation to make the underlying payment. However, the entitlement or obligation is not of itself sufficient for recognition that an amount is derived or a cost incurred under the accrual method. The amount of the underlying payment must be able to be determined with reasonable accuracy and there must be what is sometimes referred to as economic performance for the underlying payment. This means that where the underlying payment is to be made or received in return for another payment, the underlying payment is only incurred or derived to the extent the other payment has been made. This is an example where the tax accounting method of the person making or receiving the other payment is irrelevant, there must be actual payment. For example, assume that a person sells trading stock to another person in return for cash. On the signing of the contract the purchaser will be entitled to the trading stock and obliged to make the cash payment and the vendor will have the opposite entitlement and obligation. However, the vendor will not derive the cash and the purchaser will not incur the cost of the cash payment under the accrual method until either the trading stock is transferred or the cash payment is made.
114. In the case where a particular payment is made between two persons accounting for tax on different bases, the intended recipient may derive the payment at a different time than the payer incurs the payment. Where the deriving is recognised for tax purposes after the incurring, there is the potential for tax deferral. Section 48(4) is directed towards tax arbitrage in this area of timing. Tax arbitrage of this type is only possible where different persons are able to use different methods of tax accounting.
115. Under section 48(2) and (3) an amount derived or cost incurred may only be recognised before the actual underlying payment is made where the amount of the payment can be determined with reasonable accuracy. If this requirement is met, the

amount derived or cost incurred will be quantified by the rules under Subdivision C. Despite this cautious approach, it is possible that the actual underlying payment, when made, will be quantified by those rules in a different amount. A classic example of this problem is where an amount of foreign currency is considered derived or incurred before payment and by the time the actual payment is made the exchange rate of the foreign currency with the domestic currency has changed. In this case, the rules in Subdivision C will ascribe a different quantity to the payment at the time it is derived or incurred compared with the quantity at the time the payment is made. If the inaccurate earlier amount is recognised for tax purposes, it is appropriate to make an adjustment at the time of payment to ensure that the person's income is accurately calculated. Section 48(5) requires these adjustments.

116. Section 48(6) to (8) detail the adjustments required under section 48(5). These adjustments vary depending on the type of payment in question, the manner in which it is recognised for tax purposes, and whether the activities that gave rise to the early recognition on an accrual basis continue at the time the adjustment is required. The adjustments in section 48(6) to (8) are rather complex and in particular cases it may be appropriate to move them to the regulations or use a more general formula.
117. Section 49 deals with an issue that is in some ways similar to that dealt with in section 48(5). Section 48(5) provides for adjustments for quantification inaccuracies that directly result from use of the accrual method of tax accounting. By contrast, section 49 provides for adjustments for inaccuracies that result from recognition of amounts that, in hindsight, should not have been recognised or that have been reversed. In particular, it covers payments that have been refunded or recovered. It does not directly cover compensation payments, which are dealt with in section 66 and typically do not involve an intention to reverse or refund a previous payment but, rather, to mitigate the economic effects of a loss.
118. Section 49 also covers a number of inaccuracies that occur under accrual basis accounting but that are not directly caused by it. These involve recognitions that require reversal rather than adjustment in the quantity recognised, the latter being covered by section 48(5). As a result of the claim of right doctrine contained in section 41(5), a person may recognise an amount as derived or incurred because the person claims to be legally entitled to receive the amount or obliged to pay the amount. Section 49 provides adjustments where the person subsequently, but prior to receipt or payment, disclaims the entitlement or obligation. In many cases, a person may not want to disclaim an entitlement to receive a payment even though it is unlikely that the payment will ever be received, e.g. where the payment right has gone bad. The right to a payment is included in the definition of "debt claim" in section 76. Accordingly, disclaiming the right to a payment will amount to a forgiveness of debt. Instead of requiring a person to forgive a debt in order to make an adjustment, section 49 permits a person to make an adjustment where the person writes off a debt as bad.
119. Section 49(2) places restrictions on a person's right to disclaim entitlement to an amount or write off a debt as bad. This is because the adjustments on disclaimer or

writing off will often provide a reduction in income of the person in question. The manner in which financial institutions write off bad debts is often governed by prudential regulation. Section 49(2)(a) adopts this procedure in order to provide consistency. However, countries should consider whether their local prudential regulations are too liberal in this regard and expose the tax base to erosion. Other cases are covered by section 49(2)(b), which substantially limits the circumstances in which a person may make a disclaimer or write off.

120. Section 49(3) details the adjustments required under section 49(1). These adjustments are similar to those required under section 48(5) but are somewhat simpler because in this case there is a full opposite adjustment rather than a partial adjustment up or down. If the rules in section 48(6) to (8) are relegated to regulations or otherwise thought unnecessary, the rules in section 49(3) should be dealt with in a similar manner. Section 49 and the accounting rules in sections 47 and 48 may be applied a number of times with respect to a particular payment. For example, an expected payment (debt) may be included in calculating income on an accrual basis and subsequently deducted under section 49 if the debt is written off as bad. If the written off debt is subsequently recovered, section 48 will apply a second time to require the amount to be included again in calculating income.
121. Section 50 is targeted at a broader timing issue, the requirement that income be calculated for fixed periods. A contract that spans more than one time period may be structured such that deductible amounts disproportionately fall within early periods and amounts to be included in calculating income disproportionately fall within later periods. While in particular circumstances this situation may be viewed as appropriate, it also gives rise to the potential that persons will collude in structuring contracts so as to maximise tax deferral. This issue is similar to but not the same as the issue dealt with in section 48(4). That provision is targeted at potential tax deferral through the use of accrual basis accounting when compared with cash basis accounting. Section 50 addresses tax deferral under long-term contracts that may be available irrespective of the method of tax accounting used. Section 48(4) may apply in many cases where section 50 does not, e.g. to short-term contracts and payments under long term-contracts that do not breach the 80 percent rule in section 50 discussed in the next paragraph. Section 50 may apply in many cases where section 48(4) does not, e.g. to persons accounting on a cash basis and those accounting on an accrual basis where that accounting, of itself, does not present tax deferral over that available under the cash basis.
122. Where section 50 applies, the percentage of contract completed method is used to determine when amounts are derived or costs incurred under the contract. The section only applies to "long-term contracts" as defined in section 50(2). The definition has two requirements. Firstly, the contract must have a duration of at least six months and span more than one tax year. The six month period may be adjusted to suit local considerations. Secondly, the contract must be either a construction or similar contract or a "contract with a deferred return". Contracts that constitute an interest in an entity, or that are treated in a similar manner by the Sample, are excluded. "Contract with a deferred return" is defined in negative terms in section 50(8). Essentially, it is a contract

under which the return is consistently 80 percent or less of that suggested by the completed-contract method. If a party to a contract can show at least once every six months that this test is not breached, the contract is not a contract with a deferred return and section 50 does not apply to it. The section also applies to potential deferral under contracts where an overall loss rather than a profit is expected.

123. “Percentage of contract completed” is defined in complex terms in section 50(8). The method used to determine this percentage varies depending on the type of contract in question. For example, deferred interest to be paid at the end of the term of a debenture will be treated as derived by the holder proportionately over the term of the debenture. Under a construction contract, amounts are treated as derived or incurred proportionately to the percentage of total costs incurred. These and the other tests provided to determine percentage completed should be adjusted to local considerations. Further, these rules may be moved to the regulations.
124. A long-term contract will also constitute an asset or liability of the parties to the contract and consideration must be given to the effect of section 50 where the contract is transferred prior to its completion, i.e. under the transactional basis income tax. If section 50 accelerates profits to be derived under the contract, the transferor may pay tax with respect to profits that will be received by the transferee. The transferee will pay for these potential profits in acquiring the contract with the result that the transferor may be taxed a second time, i.e. with respect to any gain on the realisation of the contract. Any double taxation may be temporary and removed once the contract expires and the transferee effectively claims a deduction for the price paid for the contract. However, it is a relatively simple matter to ensure that the double taxation does not arise in the first place and this is achieved by the adjustments in section 50(6) and (7). These are similar to adjustments made elsewhere in the Sample such as to the basis of a partner’s interest in a partnership with respect to allocations of profits and distributions of the partnership, see below at paragraphs 230 and 231.
125. Finally, as mentioned above at paragraph 96, where a loss is incurred or carried forward at the end of a long-term contract, section 33(4) may permit the loss to be carried back and set against any income from the contract of prior years (that has not been reduced by other losses). This carry-back is provided to ensure that any accelerated recognition of income as a result of section 50 does not work against the person in question. That would happen if the operation of section 50 caused a loss in the final years of the contract that, absent section 33(4), would only be available for carry forward when overall the contract did not produce such a loss or produced a loss of a lesser amount.

### ***Subdivision C: Quantification of Amounts***

126. This Subdivision contains the primary rules in the Sample for quantifying amounts used in calculating income. The central provision is section 55, which incorporates rules for quantifying a payment and through those rules quantifying an amount derived or cost

incurred. The general approach is to quantify payments by reference to market value. This general approach may be inappropriate in a number of circumstances, e.g. where it is difficult to determine the extent of a payment, there is no ready market value for the payment, or the costs in determining a market value do not warrant its use. This may be the case with the provision of a motor vehicle partly for private purposes. In these types of circumstances more objective or arbitrary rules may be viewed as appropriate. Another circumstance in which a market value rule may be inappropriate is with respect to “unwanted” payments. A person may receive a payment that the person would not acquire in the market place. This can be the case with many types of fringe benefits provided to employees. In this type of case a more subjective valuation rule than the market value rule may be considered appropriate.

127. Like many other areas of an income tax, valuation rules should be adjusted to local considerations. The Sample adopts the basic market value rule but also applies examples of some different types of rules to some typically difficult areas of valuation. For example, section 55(1)(b) makes provision for more arbitrary rules in the case of the provision of a motor vehicle for private purposes. The Sample does not outline any rules in this regard but leaves them to be dealt with in the regulations, a common practice. The content of these rules often varies from country to country. In the context of employee fringe benefits, some countries use a percentage of wages, some use a flat amount per car, and in others the amount of private use is the main factor. Section 55(1)(c) provides an example of quantifying a payment according to the costs incurred by the payer in making the payment. This rule is more arbitrary than the market value rule but may be appropriate in cases where the payer is unlikely to add any substantial value to the payment over the costs incurred in making it.
128. In the case of loans at low interest rates, it may be difficult to determine what is the appropriate market interest rate in order to determine the amount of payment made in this form. As mentioned above at paragraph 84, the Sample identifies a statutory interest rate that is likely to be on the conservative side. Section 55(1)(d) uses the statutory rate to quantify the amount of a payment in the form of a low interest loan. Many unwanted types of payments will take the form of the provision of services or the use of an asset. With respect to residual payments of this kind, the Sample adopts a more subjective approach in section 55(1)(e), valuing such payments by reference to a “reasonable person in the position of the payee”. Often this will not be the market value of the payment. A common example is fringe benefits provided to government employees in developing countries. These can exceed the actual cash remuneration of such employees and are of questionable value to many of these employees. In these cases, a reasonable government employee may place a substantial discount on the market value of a particular fringe benefit.
129. Section 56 is somewhat of a supplement to section 55. It may be argued that a payment that cannot be transferred to another person or readily converted into cash has no, or a very low, market value. Section 56 overrides this argument and ensures that fringe benefits cannot easily be excluded from income of the recipient by placing restrictions on transfer or conversion.

130. Section 57 requires all amounts used in calculating a person's income to be quantified in local currency. Where an amount is not quantified in local currency, it must be converted at the time the amount is recognised for tax purposes. This approach ensures that foreign currency gains and losses are included in calculating income. This general rule can become onerous where a person is required to make numerous calculations during a tax year, such as where a person holds a foreign currency bank account and has many debits and credits during the year. In principle, each time an amount is paid from or into the account there should be a conversion. Many countries consider this approach too onerous and adopt some ameliorating rules. The Sample only adopts limited relief in this regard. The tax administration may permit a person to use an average exchange rate for conversions under section 57(3). Further, some relief may be provided in the form of the order in which foreign currency is considered realised under section 80(3), e.g. through the first-in-first-out or average-cost methods.

#### ***Subdivision D: Allocation of Income and Amounts***

131. This Subdivision is concerned with the allocation of amounts to particular persons, i.e. who is considered to derive or incur an amount. Again, the Subdivision begins in section 60(1) with the central rule that a payment is made by the "payer" and made to or received by the "payee". "Payer" and "payee" are essentially identified by reference to the definition of "payment" in section 41. Section 60(2) contains a rule targeted at diverting the receipt of a payment. It gives the tax administration power to treat a person diverting a payment as the payee or payer of the payment. For example, this power may be used to collapse back-to-back arrangements. Under section 60(2), the tax administration may also treat a payment as two separate payments, first to the intended beneficiary of the payment and a separate payment by the beneficiary to the actual payee. Section 60(2) may be used by the tax administration to prevent abuse or to relax unintended effects of the Sample. For example, it may be used in cases of direct and indirect value shifting involving independent parties, see discussion below at paragraphs 285 to 287. It might also be used to treat a person as making a payment to ensure that the person receives the benefit of the payment. For example, retirement contributions made by an employer directly to a retirement fund on behalf of an employee may be treated as made by the employee to ensure that the employee can claim a reduction of taxable income under section 191. A similar example is contributions by third parties to the purchase price of an asset, which as a result of section 60(2) may be included in the outgoings of the purchaser.

132. Section 61 provides for allocation of amounts included or deducted in calculating income between persons holding an investment jointly. It only applies to investments because two persons conducting business jointly will constitute a partnership, see the definition of "partnership" in section 105. In this case, the inclusions and deductions will be used to calculate partnership income and that income is allocated to the partners under Subdivision B of Division II of Part III.

133. Transfer pricing also involves the allocation of amounts, but this time between associated persons. Transfer pricing is dealt with under the Sample by section 62, which applies to “arrangements” between associated persons. “Arrangement” is defined in broad terms in section 345. In the case of such arrangements, the tax administration is given power to allocate amounts to be included or deducted in calculating income between the associated persons on an arm’s length basis. The provision does not go further in suggesting how the arm’s length principle may be met in specific cases. This is notoriously complex and may be appropriately dealt with in regulations or practice notes.
134. Section 63 deals with an issue that is caused by progressive taxation. It is targeted at arrangements that are commonly referred to as “income splitting”. Because different persons are taxed at different rates, a person being taxed at a high rate may seek to have some of their income allocated to a person taxed at a low rate. In many cases it will be possible to tax the high rate person on any “kick-back” received from the low rate person for the allocation of income. However, the “kick-back” may not always be readily identifiable, especially in dealings between associated persons, or may take an unrealised form, such as an increase in value of an asset held by the high rate person. Where persons attempt to reduce income tax in this manner and the requisite intention is present, the tax administration may adjust amounts to be included or deducted in calculating income so as to negate the reduction. Unlike the transfer pricing provision in section 62, this section is not limited to arrangements between associates and may apply even where the arm’s length principle is respected.

#### ***Subdivision E: Characterisation of Amounts***

135. The timing and quantity of an amount as well as its allocation to a particular person may be considered characteristics of the amount. However, in the context of income tax, a reference to, e.g. a payment being of a particular character is usually a reference to it being of a particular form or type. It is not possible to list all the forms or types that a payment may take. Some of the more important used in the Sample are annuities, capital contributions, consumption costs, capital costs, distribution of profits, natural resource payments, retirement contributions, retirement payments, repayments of capital, royalties, service fees, and wages. Another manner in which an amount may be characterised is according to its geographical source, i.e. whether the amount has a domestic or foreign source. This Subdivision deals with characterisation in the sense of the type or form and source of amounts used in calculating income.
136. Section 65 provides a general rule for characterising the type of a payment. The rule is to generally respect the legal nature of the arrangement giving rise to the payment. It is possible to adopt a substance or economic equivalence approach but this sort of approach is typically difficult to implement and creates uncertainty and inconsistency with characterisation under other areas of the law. A formal approach, such as the one adopted in the Sample, is often viewed as open to abuse. This is not the case where payments of differing characters are provided the same treatment under an income tax.

It is towards this end that, to take but one example, most forms of domestic returns on capital to non-residents are subject to the same rate of final withholding tax. Where this is not possible, e.g. with respect to the distinction between repayments of capital and returns on capital, it is necessary to supplement the formal approach. This is necessary to ensure consistency and that the income tax base is not open to substantial erosion through the re-characterisation of payments.

137. Section 66 is the first supplementary rule of this type. It concerns compensation and recovery payments. This provision is subject to section 49, which deals with the reverse of certain amounts included or deducted in calculating income. Section 49 and its relationship with section 66 were discussed above at paragraph 117. As mentioned, unlike section 49, section 66 covers payments from third parties that compensate for or represent the recovery of certain losses incurred by a person. It also covers payments for the loss of expected income and the loss in value of an asset. Section 66 does not re-characterise compensation payments according to the amount compensated for. Rather, it treats compensation payments in the manner they would have been treated if they were so re-characterised. For example, compensation for a deductible cost or lost income will be included in calculating income. This treatment is provided for in section 66(2), which is similar to the inclusive limbs of section 49(3), i.e. section 49(3)(b), (d), and (f). If the rules in section 48(6) to (8) and 49(3) are relegated to regulations or otherwise thought unnecessary, the rules in section 66(2) should be dealt with in a similar manner.
138. In contrast to section 66, section 67 actually re-characterises payments under annuities, instalment sales, and finance leases as interest and a repayment of capital paid on a blended loan. This is to ensure similar treatment between these substitutable forms of financing. Without this re-characterisation rule, payments under annuities may be considered to have purely an income character, i.e. involve no repayment of capital. By contrast, payments under instalment sales may be viewed as having purely a capital character. Payments under finance leases would be treated as the payment of rent or royalties with no part being treated as a capital payment despite substantial equivalence between a finance lease and an instalment sale. “Annuity”, “blended loan”, “finance lease”, and “instalment sale” are all defined in section 67(5). Countries with currencies particularly susceptible to devaluation may also consider re-characterising foreign currency losses on the repayment of a foreign currency loan as interest. These losses represent an interest equivalent to borrowing in local currency. Without re-characterisation, there may be a disincentive to borrowing in local currency. This will particularly be the case if foreign currency losses are deductible. In this case, withholding tax on interest paid to a non-resident lender will be less if the borrowing is in a strong foreign currency than if it is in local currency.
139. The definition of “finance lease” requires some further comment. Finance leases are treated as sales under the Sample, see section 77(3) and (4). Therefore, the definition of “finance lease” is intended to provide a list of tests where a lease may be considered essentially equivalent to a sale and, therefore, justify the treatment as a sale. As this

equivalence is a grey area and one that is often utilised by tax planners, the definition is necessarily somewhat arbitrary and therefore could be adjusted to local considerations.

140. Section 68 is the central sourcing provision. It provides rules for determining not only the source of income but also losses, amounts included or deducted in calculating income, and payments. The source of income and losses are determined separately for each earning activity of a person by reference to the source of amounts included and deducted in calculating income from the activity. So, for example, income from a business with a domestic source is determined as the excess of amounts included in calculating the income with a domestic source over amounts deducted in that calculation with a domestic source. By contrast, many countries adopt a matching approach under which the source of income is primarily determined as amounts included in calculating income with a domestic source less deductible amounts that are attributable to the inclusions, irrespective of the source of the deductible amounts. This approach is rejected as it exposes the tax base to potential erosion. This requires some further explanation.
141. As mentioned above at paragraphs 106 to 108, the income tax is primarily targeted at wealth creation or value added. In the context of domestic persons, the income tax seeks to track payments from person to person in order to identify any person by whom or in whose hands value is added and tax that person with respect to the addition. This is achieved through the netting of an intricate set of inclusions and deductions. For example, through a deduction for interest paid on a loan used in conducting a business, part of the apparent value added by a business will be allocated to the lender. Part of this value added allocated to the lender may be further allocated to other persons where the lender claims deductions. The overall system is to tax in full the net value added within a particular economy. However, if a deduction is granted against domestic value added for payments that are made outside the domestic jurisdiction, the whole of the domestic value added may not be taxed. So to allow amounts with a foreign source to be deducted in calculating domestic source income exposes the source income tax base to substantial erosion. Many developing countries experience this sort of tax base erosion by domestic activities claiming deductions for amounts paid outside the country that are not subject to withholding tax by the developing country.
142. The approach under section 68 seeks to remedy this situation by only allowing a deduction in calculating domestic source income for amounts that have a domestic source. In particular, payments that have a domestic source (for which a deduction is claimed) will typically be included in calculating the domestic source income of the payee or may otherwise be taxable, at least by way of final withholding tax. The resulting security of the tax base should ensure that the source tax base includes most all value added domestically. It should also assist in minimising "double dipping" whereby a person claims a deduction for a cost against the source tax bases of more than one country. In any case, if the allowance of deductions is viewed in terms of a negative inclusion in calculating income, it appears anomalous that positive inclusions with a foreign source are not included in calculating domestic source income whereas negative

inclusions with a foreign source may be so included. The approach in the Sample removes this anomaly.

143. Gains, losses, and allowances accounted for in calculating income are generally considered to have a domestic source where a "domestic asset" or "domestic liability" is involved. These terms are defined in sections 76 and 78, respectively, by reference to assets or liabilities held by resident persons. A branch that is situated in a country that is not the country of residence of its owner is treated as a separate person under the Sample, see section 105, and if situated domestically will be a resident person, see the discussion below at paragraph 212. Therefore, domestic assets and liabilities are essentially those held by domestic branches as well as assets and liabilities held by residents other than through a foreign branch. The exception to this general rule is with respect to land and buildings, which are considered domestic or foreign depending on their location. If the holding of land or buildings were considered, of itself, a permanent establishment, this particular exception would not be required.
144. Other amounts included or deducted in calculating income should involve an underlying payment and the source of the amount included or deducted is determined according to the source of the underlying payment. The source of payments is determined in accordance with section 68(5). The source of a payment that is a return on capital typically follows the residence of the payer. In this context, the inclusion of foreign branches within the definition of "person" in section 105 is again important. For example, in form the source of rent and royalties follows the location of the asset giving rise to the rent or royalties. However, an asset attributable to a branch will typically be located at the same place as the branch. As a foreign branch is a separate person under the Sample, the location of such a branch will typically determine the source of rent and royalties paid by it. Again, land and buildings are treated consistently with a branch and the source of rent from land or buildings follows the location of the land or buildings. By contrast, the source of a payment for services, including remuneration of an employee, typically follows the place of performance of the services.
145. Special source rules are provided for amounts used in calculating the income of a person engaged in international transportation of individuals or tangible assets. Payments for transportation commencing domestically are generally considered to have a domestic source. Repair and improvement costs and depreciation are allowed as deductions with a domestic source with respect to tangible assets used in such transportation to the extent to which the assets are used for transportation commencing domestically. The source of other amounts used in calculating income from such transportation is determined according to the general rules in section 68. These and the other source rules in section 68 may be adjusted by double tax treaties.
146. Section 68(6) essentially provides that any amount that is not treated as having a domestic source has a foreign source. However, in some cases this is not sufficient and it is important to determine the particular foreign country in which an amount is sourced. In particular, this determination is necessary in applying the country-by-country rule for quarantining the deduction of foreign losses in section 33(2), discussed above at

paragraph 92, and foreign tax offset limitations on a country by country basis under section 200(3), discussed below at paragraphs 315 and 316. Under section 68(7), the particular foreign country in which an amount is sourced is determined by applying the rules in section 68 to the country in question. In some cases, in order to determine the source of an amount it will be necessary to determine the residence of a person in a particular foreign country. This residence is determined in accordance with section 108(4), discussed below at paragraph 210.

147. Finally, the characterisation or re-characterisation of amounts is a fertile area for tax planning. Section 69 provides the tax administration with some broad powers to re-characterise income, losses, and amounts used in calculating income including payments. This re-characterisation power extends to both the source and type of the amount in question. For this purpose, the type of an amount takes an extended meaning under section 69(2). The power in section 69 is available with respect to arrangements between associates to which section 62 applies and income splitting to which section 63 applies. It also applies to "tax avoidance arrangements" and arrangements that do not have substantial economic effect. "Tax avoidance arrangement" is determined under section 69 by reference to a main purpose to avoid or reduce tax.

### **Division III: Assets and Liabilities**

148. This Division contains some general rules that apply to amounts the recognition of which is deferred under the income tax, i.e. that are not immediately included or deducted in calculating income when derived or incurred. In Anglo-Saxon terminology, these are often referred to as "capital amounts". Subdivision A contains rules that apply to such amounts that are dealt with on a transactional basis. This is the classic province of a capital gains tax. However, the relevance of the Subdivision is broader. It includes some important general definitions and covers issues such as the cost of trading stock and ordering rules for disposal of fungible assets. In essence, the transactional basis is a cautious approach (used instead of the payments basis under Division I) that seeks to ensure that transfers of assets are not taxed under an income tax. Subdivision B contains rules that apply to costs incurred with respect to depreciable assets. These costs are recognised according to the wasting nature of depreciable assets with residual transactional basis recognition. Subdivision C contains a number of special rules that detail and amend some of the general rules in Subdivisions A and B including anti-abuse rules and rules to relieve hardship in particular cases.

#### ***Subdivision A: Central Concepts***

149. This Subdivision begins with the general formula for the calculation of gains and losses from assets and liabilities. Such gains may be included in calculating income under section 17(2)(c) or 18(2)(b). Such losses may be deducted in calculating income under section 32. The formula in section 75 uses a number of concepts that are central to the Sample and particularly to Division III. Gain or loss is calculated with respect to

an "asset" or "liability". These terms are defined in sections 76 and 78, respectively. Gain or loss from an asset or liability is determined by comparing "incomings" for the asset or liability with "outgoings" for the asset or liability. These terms are defined in sections 81 and 80, respectively. The rules in Subdivision A provide for recognition of certain amounts on a transactional basis. This is achieved through the concept of "realisation", i.e. the realisation of an asset or liability determines the time at which amounts derived or incurred with respect to the asset or liability will be recognised on a transactional basis. "Realisation" is defined in section 82.

150. Section 76 contains definitions of the major types of assets recognised under the Sample and section 78 contains the complementary definitions of the major types of liabilities. Many of these definitions have been previously discussed. The definitions of "business asset", "depreciable asset", "investment asset", and "trading stock" are related and require further short comment. The dominant definition in this group is "trading stock", referred to in some countries as "inventory". "Trading stock" takes its usual meaning but specifically includes work in progress on assets that will become trading stock and inventory to be incorporated into trading stock. Unlike trading stock, which may only be held by a person in conducting a business, "depreciable assets" may be held by a person in conducting a business or investment. These are wasting assets that are the primary subject of Subdivision B. "Business asset" is essentially the residual category of assets held in conducting a business. "Investment asset" is also residual in this sense but, as discussed above at paragraph 49, is central to the identification of an activity as an investment.
151. The general definitions of "asset" and "liability" also require further comment. In order to provide a broad base under an income tax, "asset" is often defined in terms of legal rights. Income taxes often do not deal with liabilities in a comprehensive manner. In order to do so, "liability" may be defined in terms of legal obligations. In this context, it is necessary to determine whether rights and obligations are to be recognised on an individual basis, e.g. on a right-by-right or obligation-by-obligation basis, or under some other grouping approach. In practice, some form of grouping approach is invariably adopted, either expressly or implicitly. This appears necessary as the individual approach to rights and obligations is likely to be administratively unworkable. Under a grouping approach, it is necessary to group rights and obligations so as to properly identify assets and liabilities for income tax purposes.
152. The conventional meanings of "asset" and "liability" are often sufficient for identification purposes. However, there will be cases producing some uncertainty. For example, while at the extremes the difference between an asset and a liability is obvious, there will be cases where it is not clear whether a particular group of rights and obligations is an asset or a liability. Appropriate identification is important as different consequences may result depending on whether an asset or liability is involved. In particular, where amounts derived from an asset exceed costs incurred for the asset, there is a transactional reconciliation, i.e. a realisation giving rise to a capital gain. This is not the case with a liability as amounts derived in respect of incurring a liability are

often expected to exceed costs incurred for the liability at some stage while the liability is outstanding.

153. The definitions of "asset" and "liability" do not adopt specific grouping rules for identifying assets and liabilities. Rather, a general principles approach is adopted. The definitions make it clear that a particular asset may incorporate not only rights but also obligations and a liability may incorporate not only obligations but also rights. For example, the rights and obligations of a lessee under a lease are not separated into a group of rights and another group of liabilities. Rather, rights and obligations are grouped along traditional property lines. That is, rights and obligations typically associated with a particular form of property are grouped for the purposes of identifying assets and liabilities under the Sample. Not all rights may be viewed as falling within traditional notions of "property", e.g. there is often a question as to whether certain rights to information or know-how are property. Accordingly, the residual grouping rule groups rights and obligations that are integrated or amalgamated. If a right or obligation cannot be grouped under the residual rule, it is dealt with in isolation.
154. After grouping rights and obligations, an assessment must be made as to whether a particular group is an asset or liability. This is essentially an issue of whether the group has a positive market value or a negative market value. If the group has a positive or nil market value at the time the rights and obligations are acquired, the group is considered an asset. If the group has a negative market value at this time it is considered a liability. In practice, it is possible that during the holding of an asset it will turn into a liability or a liability will turn into an asset. However, under the Sample a group of rights and obligations is only identified as an asset or liability once, i.e. at the time of acquisition. This approach provides certainty and does not appear open to any substantial abuse.
155. Both the definition of "asset" and that of "liability" have a short inclusions head. These are essentially self-explanatory. "Part" of an asset or liability is included in order to ensure that the calculation of gain or loss provisions work appropriately where only part of an asset is realised. The definitions also have an exclusions head. The exclusion of entitlements and obligations referred to in section 48(2)(a)(i) and (3)(a)(i) is to avoid the need for reconciliation that might otherwise be required as a result of recognising amounts under the income tax on an accrual basis before they are paid. Insurance and compensation rights are also excluded from the definition of "asset" where they are associated with a primary asset or liability. Payments under these rights will be taken into account in the calculation of any gain or loss with respect to the primary asset or liability.
156. Sections 77 and 79 provide essential rules that allocate assets and liabilities to particular persons. Gains and losses on the realisation of an asset or liability may only be included in calculating a person's income where the asset or liability realised is the person's asset or liability, see sections 17(2)(c), 18(2)(b), and 32. This allocation is to the person who "owns" an asset or "incurs" a liability and is generally made at the time that ownership begins or the liability is incurred. Section 77(2) provides a special rule applicable to arrangements under which a third party provides a business with trading

stock available for sale in the ordinary course of the business where ownership in the stock does not pass by the time the stock is first available for sale. Showroom leases to car sale retailers are an example. Section 77(2) and (4) treat such arrangements as a sale and transfer of ownership at the time the stock is first available for sale. This is essentially a substance over form rule and ensures that the provisions applicable to trading stock operate consistently. Similarly, section 77(3) and (4) treat the lease of an asset under a finance lease as a sale and transfer of the asset. Finance leases were discussed above at paragraph 139.

157. Sections 80 and 81 identify amounts that are subject to treatment under the transactional basis income tax. This identification is most important in securing a comprehensive tax base. In order to explain this importance, it is necessary to return to the conceptual base of the income tax. As discussed above at paragraphs 65 and 106 to 108, an income tax is primarily targeted at wealth creation or value added. This typically has two aspects, the largest of which is likely to be through the provision of labour and capital with the smaller aspect being any net increase in the value of an economy's existing assets. The primary calculation provisions in Division I, i.e. the payments basis income tax, are intended to reflect the larger aspect. The transactional basis rules in Division III have two primary purposes. Perhaps the dominant purpose is to cover any holes in Division I. In this sense, the transactional basis rules are a large anti-avoidance rule for the dominant tax base, i.e. the payments basis income tax. The second primary purpose of the transactional basis rules is to cover the smaller aspect of wealth creation, i.e. any net increase in the value of an economy's existing assets. Where there is a net decrease in the value of an economy's assets, the transactional basis rules may give rise to an overall loss of tax revenue. Another purpose of the transactional basis income tax is to make appropriate adjustments between persons for relative changes in the value of assets and liabilities.

158. The transactional basis rules, therefore, are very broad and, absent reconciliation rules, cover any amount recognised under Division I. Under the transactional basis, amounts to be recognised are allocated to particular assets or liabilities. So, for example, if wages were not included in calculating income on the payments basis, they would be recognised under the transactional basis by allocation to the employee's employment contract. Costs incurred that are allocated to an asset are conventionally referred to as the asset's "cost base". However, as mentioned at paragraph 151, income tax laws often do not comprehensively deal with liabilities and, indeed, liabilities are sometimes treated as falling within the definition of "asset". In these types of circumstances, countries often struggle with the concept of a "negative" cost base. The "cost base" of an asset typically represents costs incurred with respect to an asset less any amounts derived with respect to the asset, disregarding any costs or amounts recognised on a payments basis. "Cost base" is therefore, typically a net concept.

159. In order to avoid the problems associated with the potential for negative cost bases, the Sample focuses on amounts that are to be recognised only on a transactional basis. Costs of this type incurred with respect to assets and liabilities are referred to as "outgoings", a term defined in section 80. Amounts of this type derived with respect to

assets and liabilities are referred to as "incomings", a term defined in section 81. These amounts may be netted at any particular time, including on realisation of an asset or liability, in order to calculate "net outgoings" or "net incomings" for a particular asset or liability. These terms are defined in section 345. "Net outgoings" for an asset are essentially equivalent to a conventional reference to the asset's "cost base". "Net incomings" for a liability is, therefore, equivalent to the "negative cost base" of a liability. This terminology may be adjusted to suit local considerations.

160. Further specific comment is required with respect to sections 80 and 81. Under section 80, the outgoings for an asset or liability fall under three main heads, ignoring the incidental costs head. The first only applies to assets and includes costs in acquiring an asset. These include, where relevant, costs of constructing an asset. Section 80(1)(a)(ii) may also include amounts by way of reconciliation. It may be that the acquisition of the asset is a payment by a third party for wealth created by the acquiring person. An example is where an employer pays an employee with an asset rather than cash. The payment, being the transfer of the asset, will be included in calculating the employee's income and be taxed to the employee. It is inappropriate to tax the wealth created a second time on a transactional basis when the asset is realised by the employee. It is possible to address this reconciliation by including as an outgoing any "payment" made by the person in acquiring the asset. However, this would mean that any wealth creation that escaped Division I would not be covered by the transactional basis in Division III.
161. The second head of outgoings applies to both assets and liabilities, covering any costs incurred in owning the asset or owing the liability in question. Again there are specific inclusions, the most notable being costs of repair and improvement. There is a similar reconciliation rule to that provided under the first head. The third head also applies to both assets and liabilities and covers costs of realisation.
162. The resuming words in section 80(1) provide for some specific exclusions from the outgoings for an asset or liability. Outgoings under the transactional basis income tax are analogous to deductions under the payments basis income tax. It is, therefore, necessary to exclude "consumption costs" and "excluded costs" for similar reasons to those discussed above at paragraphs 71 to 75 in the context of section 25. The specific exclusions also provide a reconciliation rule. Amounts that may be deducted under the payments basis income tax are excluded from the outgoings for an asset or liability to prevent "double dipping", i.e. double relief for the same cost.
163. Section 80(2) is a special rule that overrides section 80(1) in determining the outgoings for trading stock. This provision is directly related to the deductible allowance granted for the cost of trading stock under section 28. Again the approach is to adopt generally accepted accounting principles in the form of the "prime-cost" and "absorption-cost" methods of costing trading stock. These and related terms are defined in section 80(4) in conventional terms.

164. Section 80(3) is also a special rule that applies generally accepted accounting principles, this time in allocating outgoings to assets that are difficult to identify. For example, the quantity and nature of particular units of trading stock held by a business may make it difficult to identify which units are sold in a particular transaction and, therefore, which outgoings should be taken into account with respect to the sale transaction. The issue may be addressed either through flexible rules for identifying the trading stock considered sold or through flexible rules in allocating outgoings to the trading stock actually sold. Section 80(3) adopts the latter approach. Where trading stock is fungible and not readily identifiable, the owner may elect to use the "first-in-first-out" or the "average-cost" method for determining the outgoings for trading stock. These terms are defined in section 80(4) in conventional terms. This identification problem is not limited to trading stock. Therefore, the application of section 80(3) may be extended to other types of assets by the regulations. The types of assets that may be considered for this treatment include securities held in entities.
165. The structure of section 81 in identifying incomings for assets and liabilities reflects the structure of section 80(1). Just as the first head of section 80(1) only applies to assets, the first head of section 81 only applies to liabilities. The second and third heads also follow similar lines to those in section 80(1). However, the reconciliation rules in section 80(1)(a)(ii) and (b)(iii) are not reflected in the first and section heads of section 81. This is because of the nature of amounts that may be included as incomings for an asset or liability. Outgoings for an asset or liability may only include "costs incurred". As discussed above at paragraphs 106 to 108, this term is defined by reference to only the first head of the definition of "payment" in section 41. By contrast, incomings for an asset or liability include "amounts derived" in respect of the asset or liability. This term is defined by reference to all heads of "payment" and so the reconciliation rule is not required.
166. The third head of incomings includes not just amounts derived but amounts "to be" derived in respect of a realisation of an asset or liability. The effect is to accelerate the recognition of such amounts under the transactional basis income tax, perhaps to an even greater extent than under the payments basis income tax. This aspect is again one of protecting the tax base and is intended to ensure that, e.g. sales with delayed payments of the purchase price do not give rise to a formal loss (with no economic substance) at the time of sale. In the case of sales, this provision will only apply to short-term delays (less than one year from the realisation). Delays of a greater length will result in characterisation of the sale as an instalment sale. Payments under instalment sales are subject re-characterisation as interest and a repayment of capital on a loan under section 67, discussed above at paragraph 138. In conjunction with section 67, instalment sales are also subject to a special market value rule under section 91, discussed below at paragraph 186. The reconciliation rules in the resuming words of section 81 exclude amounts "to be" included in calculating a person's income. The net result is that the third head of incomings in section 81 only accelerates the recognition of amounts that will not be directly included in calculating income. Amounts that will be so included are recognised on the payments basis.

167. The realisation of an asset or liability determines the time at which amounts derived or costs incurred with respect to the asset or liability will be recognised on the transactional basis. "Realisation" is defined under a number of heads in section 82(1) for assets and 82(2) for liabilities. There are a number of common heads of realisation in section 82(1) and (2) and these heads fall into two broad categories. The first two heads cover situations in which the person owning the asset or owing the liability parts with that ownership or the obligations constituting the liability. The remaining heads under both section 82(1) and (2) cover situations in which the person owning the asset or owing the liability does not formally part with the ownership or obligations. Nevertheless, the situations outlined under these heads are felt to justify recognition of amounts derived and costs incurred on a transactional basis.
168. The first head of "realisation" covers situations in which the person parts with ownership of an asset or the obligations of a liability. Importantly, a person need not part with the asset or liability in favour of another person. This head also covers the destruction of an asset or liability and any other manner in which an asset or liability may cease to exist. The related second head covers the situation where the person in question ceases to exist, e.g. where an individual dies. This head also applies to entities, e.g. where an entity is dissolved. The Sample adopts the approach that all gains or losses with respect to an asset or liability should in principle be allocated to the person holding the asset or owing the liability at the time the gain or loss accrues. This means that the death of an individual is viewed as the final time of reconciliation for gains or losses accruing during the life of the deceased.
169. This approach does not turn the income tax into an inheritance tax. An inheritance tax is a tax on the transfer of assets and, as mentioned above at paragraphs 65 and 106, the income tax is primarily targeted at creations of wealth. With respect to assets and liabilities passing on an individual's death, the Sample only reaches gains or losses that accrue to the deceased, the recognition of which were delayed during the deceased's life. Many countries provide some relief from the recognition of gains at death. However, this approach almost invariably causes distortions. It will either encourage or discourage the transfer of assets before death or at the time of death. The approach in the Sample is to treat either form of transfer in the same manner. Nevertheless, the approach in section 82 may not be acceptable to particular countries and the approach should be adjusted to account for local considerations.
170. The third head of realisation for assets occurs where the incomings for an asset exceed the outgoings for the asset. The reason for this head is again related to the income tax being primarily targeted at creations of wealth. The transactional approach is a cautious approach that measures wealth creation with respect to a transaction, e.g. in the case of acquisition of an asset, only when the transaction is completed, typically when ownership of the asset is parted with. To recognise incomings for an asset prior to the end of the transaction may result in the effective taxation of money or assets that were transferred by a person in acquiring the asset, i.e. money or assets reflected in outgoings for the asset. Again, the income tax is not a tax on the transfer of assets. However, where the incomings for an asset exceed the outgoings for the asset it is clear

that the excess does not represent the transfer of money or assets in acquiring the asset in question, i.e. it most likely represents wealth created in the person owning the asset. It is, therefore, appropriate to tax the excess on a payments basis and this is the effect of the third head.

171. The fourth head of realisation for assets deals with bad debts. Section 49 also deals with bad debts and some explanation of the interaction between the two provisions is required. Essentially, section 49 deals with debt claims that were recognised on a payments basis as an inclusion in income of the holder of the debt claim. By contrast, section 82(1)(d) deals with debt claims that are only to be recognised to the holder of the claim on a transactional basis. The classic type of debt claim to which this provision applies is a loan. The purpose of the provision is to permit a person to recognise, in particular, losses on debt claims where the debt claim has become a bad debt. The tests for determining whether or not a debt claim is a bad debt claim are essentially the same as discussed in the context of section 49 at paragraphs 118 and 119.
172. As mentioned at paragraph 107, the income tax does not typically cover wealth created through the holding of all types of assets and liabilities, it only covers assets used in an earning activity. The treatment of amounts recognised under the transactional basis income tax may vary depending on the type of earning activity in which an asset or liability is used, e.g. the varying treatment of losses under section 33. Therefore, tax arbitrage is possible, e.g. by removing an asset with an unrealised gain from an earning activity and using it in a non-earning activity such as leisure or consumption. In order to protect the tax base, the fifth head of realisation for assets deals with changes in use of certain types of assets. Where an asset of a particular type within the tax net is used in such a manner that it ceases to be an asset of that type, it is treated as realised.
173. The last three heads of realisation are the same for assets and liabilities. Foreign currency assets and liabilities, defined in sections 76 and 78, are treated as realised at the end of each year. In the absence of this provision, a person is more likely to realise foreign currency losses and seek to prevent the realisation of foreign currency gains. While this is a generic problem with transactional basis income tax, it is particularly acute in the context of foreign currency assets and liabilities, where realisation is a relatively simple matter. An alternative approach is to quarantine foreign currency losses so that they may only be set off against foreign currency gains. Again, this is an issue that should be adjusted to local considerations including any exchange restrictions. There is also a realisation of all the assets and liabilities held by an entity where there is a change in control of the entity in the terms of section 171(1), discussed below at paragraph 281. The final head of realisation occurs where a person becomes a non-resident. This head treats as realised an asset or liability that will fall outside the tax net after the change in residence. The tax administration is granted power to override this realisation.
174. The definition of "realisation" does not cover a quasi-parting of ownership of an asset through borrowing with respect to the asset. It is often viewed as abusive that a person may borrow money on the security of an unrealised gain on an asset and thereby

obtain the use of the gain without having to recognise the gain for tax purposes. There are difficulties in seeking to address this issue. One problem is allocating funds borrowed to unrealised gains and another is the requirement for market valuations. One possible approach is to adopt a presumptive rule. For example, funds borrowed by a person, unless specifically secured by an asset outside the tax net, may be considered incomings for assets of the person used in earning activities up to the market value of those assets. The person would be permitted to allocate the incomings among the assets at their selection. Such a rule may go a long way to addressing any perceived abuse of the transactional basis income tax. However, this does not reflect common international practice and is not adopted in the Sample.

### ***Subdivision B: Depreciable Assets, Allowances, and Inclusions***

175. The primary treatment of outgoings for depreciable assets under the Sample is to recognise the wasting character of such assets and provide a deductible allowance under section 31 for each tax year at the end of which a depreciable asset is held. This recognition of outgoings is provided without the requirement of a realisation. Where a depreciable asset is realised, the transactional basis income tax is applied in a residual manner by way of reconciliation with the allowance system.
176. Subdivision B pools, for each earning activity, the treatment of assets that waste at broadly similar rates. The exception is with respect to buildings and similar assets that typically have a slow wasting rate as well as intangible assets. The pooling approach is viewed as having compliance cost benefits over depreciation on an asset by asset basis with a minimal loss of accuracy, if any. Each depreciable asset is categorised as being of a particular Class by section 85(1). The inclusions in Classes 1 to 6 are intended to represent assets that will waste at similar rates. This classification is only an example, and this is another issue that should be adjusted to local considerations. Section 85(2) provides for the pooling of assets of a particular business or investment. Class 1 to 5 assets are generally pooled with all assets of the business or investment of the same class. Class 6 and 7 depreciable assets are pooled individually.
177. There are special pools required by section 85(2)(c) for assets used to transport individuals and goods. This is in order to facilitate apportionment in determining the source of a depreciation allowance under section 68(4)(b)(i), discussed above at paragraph 145. There are also special rules for costs incurred in respect of natural resource prospecting, exploration, and development. Often these costs will not be incurred with respect to a particular asset such as a mining right. This might happen where the prospecting or exploration is unsuccessful. These costs might be deductible immediately. However, the costs incurred in uncovering a viable natural resource deposit are typically low compared with the value of the deposit or right to the deposit. In many ways, the costs incurred on unsuccessful prospecting and exploration are incurred with respect to the finding of the odd viable deposit and may be allocated to it. The Sample does not adopt this allocation process directly but does provide for the

depreciation of these types of costs as though they were incurred in acquiring an asset, see section 85(3).

178. Standard depreciation allowances are calculated under section 86. The general formula in section 86(2) involves the application of the relevant depreciation rate to the depreciation basis of each pool of depreciable assets at the end of a tax year. The rates are provided in section 86(6) and are mere guides that should be adjusted to suit local considerations. Only in the case of intangible depreciable assets is the rate directly determined according to the useful life of the asset. The depreciation basis of pools at the end of a tax year are determined under section 86(3) and (4) for Class 1 to 5 and Class 6 and 7 pools, respectively. Under each provision, outgoings for a depreciable asset in a pool are added to the depreciation basis of the pool. Class 1 to 5 pools are also reduced by two types of amounts. The first type of reduction is for depreciation granted. This means that depreciation allowed for Class 1 to 5 pools is calculated on a diminishing value basis. Further, the depreciation basis of a Class 1 to 5 pool is decreased by incomings for assets in the pool during the year. The main type of incoming for treatment in this manner is amounts derived in respect of the realisation of assets in the pool.
179. By contrast, the depreciation basis of Class 6 and 7 pools (buildings and intangibles) are not written down, meaning that the application of the depreciation rate produces straight line depreciation. Section 86(8) contains the necessary rule for limiting the amount of depreciation allowances under this method to the depreciation basis of the relevant pool. Whether and where the diminishing value or straight line depreciation methods are used is another issue that should be adjusted to local considerations. However, only the diminishing value method is consistent with pooling the treatment of multiple assets.
180. Section 86(5) contains a rule that may delay the inclusion of part of outgoings for a depreciable asset in the depreciation basis of the pool in which the asset is placed. Without a delay rule, there is an incentive for a person to incur costs with respect to depreciable assets just before the end of a tax year. Such a person would otherwise be granted the same depreciation allowance for the year as a person who incurs similar costs at the start of the year. The most accurate rule is to apportion the inclusion on a daily basis. For the sake of simplicity, the Sample adopts a more arbitrary approach based on quarters of a year. Only a portion of outgoings for depreciable assets is included in the depreciation basis of the relevant pool in the tax year they are incurred, depending on the quarter in which they are incurred. The balance is added to the depreciation basis of the pool during the following tax year.
181. Section 86(7) contains a special rule permitting the writing off of small residual balances in the depreciation basis of a pool of depreciable assets. The relevant threshold must be adjusted to local considerations. Section 86(9) contains another special rule limiting the depreciation of luxury road vehicles. This is an arbitrary rule seeking to prevent a person from claiming depreciation with respect to road vehicles to the extent that they may be considered attributable to consumption or leisure activities. Road

vehicles are a particular problem in this area justifying their special treatment under the Sample. Again however, this is only an example of a generic issue and such an arbitrary rule may be applied to other types of depreciable assets. This rule and the threshold it incorporates should be adjusted for local considerations.

182. Section 87 contains the residual transactional basis treatment of depreciable assets of a business or investment. This residual treatment will either result in the inclusion of an amount in calculating income from the business or investment under section 17(2)(d) or 18(2)(c) or a further depreciation allowance that is deductible in the calculation under section 31. Section 87(1) contains a special rule applicable to depreciable assets in Class 1 to 5 pools. The assets in such pools are essentially treated on a single asset basis. In this context, section 87(1) contains a rule that reflects the application of section 82(1)(c) to other types of assets. In essence, where incomings for a person's assets in a Class 1 to 5 pool derived during a tax year exceed the depreciation basis of the pool, the excess is included in calculating the person's income.
183. By contrast, section 87(2) applies where a pool of depreciable assets is emptied by the end of a tax year, i.e. where all the assets in the pool are realised. In this case, no depreciation is allowed under section 86 in respect of the pool for the year. Rather, the transactional basis income tax is used to make appropriate adjustments by essentially comparing the written down value of the pool with incomings for the assets that were disposed of during the year. Any excess of incomings is included in calculating the income of the relevant business or investment for the year. Any excess of written down value is granted as an allowance that is deductible in calculating that income. "Written down value" for this purpose is defined in section 87(4). In the case of Class 1 to 5 pools it is essentially the depreciation basis of the pool. In the case of Class 6 or 7 pools, it is essentially the depreciation basis of the pool less depreciation allowed in respect of the pool.

### ***Subdivision C: Special Rules***

184. This Subdivision contains a number of special rules that apply to the transactional basis income tax. Many of these rules are complex, some are essentially policy issues, and so are optional, and others may or may not be appropriately dealt with by accounting rules. In all cases these rules must be adjusted to suit local considerations. The approach in the Sample is to provide an example of a relatively comprehensive set of rules that do not rely on accounting rules.
185. The first special rule deals with situations in which a person is considered to realise an asset or liability but has not formally parted with the asset or liability. These situations were discussed above at paragraphs 167 and 171 to 173. The general approach in section 90(1) and (4) is to treat realisation as at market value and to effectively reset the net outgoings or net incomings for the asset or liability to that value. In the case of the realisation of an asset by way of change of use of the asset, section 90(2) essentially permits non-recognition provided the asset stays within the tax net.

Section 90(3) is a variation of this rule to cater for this type of realisation of depreciable assets, which are subject to the pooling provisions discussed above at paragraphs 176 to 177.

186. The second special rule applies a market value rule to assets realised by way of instalment sale or finance lease. This integrates with the re-characterisation rule in section 67, discussed above at paragraphs 138 and 139. Section 67 treats payments to be made under instalment sales and finance leases in excess of the market value outgoings allocated to the asset by section 91 as interest, to be included directly in calculating income.
187. Section 92 applies a limited non-recognition rule to the transfer of assets and liabilities between spouses. It only applies where the transfer is part of a divorce or separation agreement. This situation is analogous to involuntary realisations covered by section 96 but in this case the transferor need not acquire a replacement asset and an election by the transferee is required (since the transferee may be accepting an underlying tax liability). Some countries allow non-recognition of transfers between spouses on a broader basis. However, where, as under the Sample, the individual is the tax subject, a broader rule may give rise to income-splitting opportunities. A market value rule is otherwise applied in the case of transfers between spouses, see section 94.
188. Section 93 contains a market value rule for transfers resulting on the death of an individual. Typically, this transfer will be, in the first instance, to the deceased's estate, which will be administered by an executor or administrator. The estate will be a trust and, therefore, treated as a separate person under the Sample, see section 105. As a result of section 93, the deceased may realise gains or losses from the realisation of assets and liabilities that must be included in calculating the deceased's income, see the discussion above at paragraphs 168 and 169. The executor or administrator will be required to pay any outstanding tax of the deceased by reason of section 281. The estate will have market value outgoings with respect to assets transferred from the deceased and market value incomings for transferred liabilities. Any further transfer to a beneficiary of the deceased will also be treated as made at market value, see section 94. The result is likely to be no gain or loss to the estate and market value outgoings for assets or market value incomings for liabilities for the beneficiary. Some gain or loss to the estate may occur in isolated circumstances, e.g. where there is substantial delay between the date of death and the date of transfer to the beneficiary.
189. Special rules also apply to transfers between associates or for no consideration. These are of the typical form in section 94(1) and (4), which apply market value to the transfer except where this would result in the recognition of a loss. This exception seeks to deter "wash sales" between associates whereby persons seek to realise assets and liabilities with underlying losses by transferring them to associates while preventing realisation of any assets or liabilities with underlying gains. By contrast, section 94(2), (3), and (5) contain special rules that may allow a person transferring an asset or liability to an associate to not recognise a gain. Section 94(2) applies generally to assets within the tax net with section 94(3) catering specifically for depreciable assets, which are

subject to the pooling provisions discussed above at paragraphs 176 to 177. Section 94(5) applies to liabilities within the tax net. Non-recognition under each of these rules is subject to the requirements in section 94(7).

190. The first requirement in section 94(7) is that either the transferor or the transferee is an entity. The second is that the asset or liability remains in the tax net in the hands of the transferee. For this reason, both the transferor and the transferee must be residents. Because foreign branches are treated by the Sample as persons, this means that the transfer may be between a domestic subsidiary and a domestic branch of a non-resident person. The third requirement is that there is 50 percent continuity of underlying ownership or underlying obligation in the asset or liability, respectively. Because the operation of section 94(2), (3), and (5) are likely to result in the transfer of a tax liability, the last requirement is that both the transferor and the transferee elect for the non-recognition.
191. The first and third requirements in section 94(7) are worthy of further consideration. The main justification for non-recognition treatment in transfers between associates is where there is in substance no realisation, only a change in the form of holding the asset or owing the liability. This is clear where there is 100 percent continuity of "underlying ownership" or "underlying obligation" in the asset or liability, respectively. These terms are defined in section 345. The underlying ownership of an asset owned by an entity or underlying obligation of a liability owed by an entity is determined by reference to the holding of interests in the entity. That holding is determined by looking through entities that hold interests in other entities until an individual or an entity in which no person has an interest is identified. "Interest" in an entity is defined in section 106 and discussed below at paragraph 205. Underlying ownership and underlying obligation are only relevant in the context of assets or liabilities where they are owned or owed by entities. This means that non-recognition treatment is available under section 94(2), (3), or (5) only where either the transferor, the transferee, or both are entities, i.e. non-recognition is not available for transfers between associated individuals.
192. The justification for non-recognition of gains under section 94(2), (3), and (5) is not as clear where continuity of underlying ownership or underlying obligation is less than 100 percent. In this case, in the absence of sophisticated rules, non-recognition will give rise to the transfer of tax attributes between persons, something that is generally resisted under an income tax for tax arbitrage reasons. However, to deny non-recognition will result in a "lock-in" effect whereby persons will resist restructuring the manner in which their assets are held or their liabilities are owed for fear of realising a taxable gain, even where restructuring may be the commercially efficient alternative. There appears no easy way to deal with this issue and the Sample adopts somewhat of a compromise. It allows non-recognition where there is continuity of underlying ownership or underlying obligation of at least 50 percent. This is consistent with the approach adopted with respect to the transfer of losses under section 33(1)(c), discussed above at paragraphs 93 and 94, and the transfer of foreign income tax under section 200(3)(b), discussed below at paragraph 316. These discussions are also relevant to the requirement that the transferor and transferee both be residents. The potential for tax arbitrage is left to the

value shifting rules in sections 173 and 174. Further, the transfer pricing rule in section 62 may be applied if one of the main purposes of the transfer is the reduction of tax, i.e. to secure non-recognition the transfer must be for other main purposes, see section 94(6).

193. The non-recognition rules in section 94(2), (3), and (5) are important and have potentially broad application. They can apply to contributions to an entity in which the contributor holds a 50 percent interest, e.g. on the incorporation of a business. They can apply on the reconstruction of an entity including mergers and demergers as well as the addition and departure of partners of a partnership. They can also apply to transfers on the winding up of an entity. Whether more sophisticated rules are desired for particular cases and whether the threshold of 50 percent underlying ownership or underlying obligation is too low or even too high are issues that must be adjusted to suit local considerations.

194. Section 94 only applies to transfers between associates. It is also possible to effect the economic equivalence of a transfer between associates by the creation of a liability in one person that constitutes an asset of an associate, e.g. by granting an option to purchase an asset. Section 95 is targeted at this situation and provides a market value rule that applies to both the creation of the asset and liability and their simultaneous realisation.

195. Section 96 provides non-recognition treatment for involuntary realisations by way of parting with ownership of assets or obligations of liabilities. Non-recognition is available where a replacement asset or liability is acquired or incurred within one year of the realisation. The rule is complicated somewhat by covering situations in which the replacement asset or liability is of a greater or lesser value than the asset or liability realised. These situations may result in part recognition of any gain. Non-recognition only applies where the person makes an election. The section does not define "involuntary", which will take its ordinary meaning. The application of the term to particular circumstances may be an appropriate subject for practice notes. However, "involuntary" would not cover, e.g. the exchange of securities in a merger. This is a situation in which relief is often provided in order to prevent lock-in. This lock-in is similar to that which may occur through the taxation of transfers between associates and which is addressed by section 94, see discussion above at paragraph 192. Section 96(7) provides that the regulations may treat an exchange of securities as an involuntary realisation.

196. Section 97 and 98 deal with two particularly difficult issues. The separate existence of an asset or liability (the "merging asset or liability") may be extinguished where it is combined with another asset or liability (the "combined asset or liability"). As the holder of the merging asset or liability will no longer own or owe the asset or liability, the holder will realise the asset or liability. It is possible for an asset to be combined with an asset or a liability and for a liability to be combined with an asset or a liability. Section 97(2) provides a non-exhaustive list of some circumstances in which section 97 applies. Where it applies, section 97 provides a non-recognition of any gain or loss from

the realisation of the merging asset or liability with an appropriate adjustment to the outgoings and incomings for the combined asset or liability. This rule is complicated by the possibility, e.g. via section 97(1)(b), that the addition of net incomings for a merging liability may turn the net outgoings for a combined asset pre-combination into net incomings for the asset post-combination. In this case, the non-recognition rule only partly applies and a part gain may be recognised for the realisation of the merging liability. This is consistent with the approach to realisation in section 82(1)(c), i.e. where the incomings for an asset exceed the outgoings for the asset, and is appropriate for the reasons discussed above at paragraph 170. Section 97(1)(a) covers the opposite variation on this theme and may result in partial recognition of a loss on realisation of a merging asset.

197. Section 98 deals with the related issue of separation of assets and liabilities. The issue is whether the creation of rights or obligations with respect to an asset or liability is a part realisation of the asset or liability or the creation of a new asset or liability. The classic example is where a person creates a lease over an asset owned by the person in favour of another person but would also extend to cover other arrangements such as a usufruct or option. Section 98 takes the approach that where the rights are permanent there is a part realisation of the asset or liability. Where they are temporary there is no part realisation but, rather, the creation of a new asset or liability. So the granting of a lease or option with respect to an asset or liability is not typically treated as a part realisation. This is the preferred approach because it avoids problems with, e.g. persons claiming partial losses where assets are leased (due to apportionment of any net outgoings to the part realised) or the need to recognise a part re-acquisition when temporary rights expire. "Permanent" is not defined and so will take its ordinary meaning. Section 98 is subject to section 77(4), discussed above at paragraph 156, a provision that treats finance leases as sales. So even though rights and obligations under finance leases may only be temporary, they are treated as a realisation. On expiry of a finance lease, there may be a re-acquisition by the lessor of the asset, see section 77(5).
198. While section 99 is the longest non-interpretative section in the Sample, it deals with a relatively simple issue. Its purpose is stated in section 99(1) as to provide an apportionment of outgoings and incomings over more than one asset or liability in the situations described in section 99(2) to (4). Section 99(2) covers the situation in which, e.g. a person makes one payment in acquiring a number of assets with or without a number of associated liabilities such as in the acquisition of a business. Section 99 apportions the price paid as outgoings and incomings for individual assets and liabilities by comparing the market value of assets acquired and the market cost of liabilities incurred. This is the general approach adopted with respect to all the situations covered by section 99.
199. Section 99(3) covers the opposite situation to section 99(2), i.e. where a person transfers more than one asset or liability at the same time or under the same arrangement. For example, it covers the vendor in the sale of business example provided in the last paragraph. The third situation, covered by section 99(4), is where a person realises only part of an asset or liability and retains the remainder. Section 98,

discussed above at paragraph 197, is relevant in determining if there is a part realisation. The purpose of section 99 in this situation is to apportion any net outgoings or net incomings for the asset or liability in question between the part of the asset or liability realised and the part retained.

200. The general apportionment formula is contained in section 99(5) and (6). This formula, and the related definitions and formulas in section 99(8), are complex for a number of reasons. Firstly, there is the potential that the netting of the market value of the assets and liabilities subject to apportionment does not equal the payment for the assets and liabilities under section 99(2) or (3), or may not equal the net incomings or net outgoings for the asset or liability under section 99(4). This is why section 99(5) and (6) deal with excess value and inadequate value, respectively. Complexity also results from catering for positives and negatives, i.e. the positive market value of assets as well as the negative market value of liabilities. Again, the approach under section 99 is to provide an example of a comprehensive rule. This rule may be too complex for local conditions. It may be moved to the regulations or a more general rule adopted and the difficult issues covered by section 99 dealt with in practice notes.

## **PART III: RULES GOVERNING TYPES OF PERSONS**

201. This Part moves to provide special rules that apply to particular types of persons or by reason of the involvement of a particular type of person in an arrangement. It is divided into three divisions. The first is again a general concepts division and contains some central definitions that are of particular relevance to particular types of persons and in considering the treatment provided by the rest of the Part. Division II is divided into a number of subdivisions that each provides special rules devoted to a particular type of person. By contrast, the rules in Division III apply generally to entities.

### **Division I: Central Concepts**

202. This Division contains a number of definitions that are not only central to this Part but to the Sample as a whole. They are the definitions that make distinctions between different types of persons. Section 105 begins with the primary distinctions. Section 105(1) initially distinguishes between natural persons and artificial persons, i.e. individuals and entities. Non-exhaustive subcategories of individuals are "minors" and "incapacitated individuals". Exhaustive subcategories of "entities" are "partnerships", "trusts", "companies", and "foreign branches". Subcategories of "trusts" and "companies" are "controlled foreign trusts" and "controlled foreign companies". All of these terms are defined in section 105(2).

203. The reason for these distinctions is that different types of persons receive different tax treatment under the Sample. An overview of this treatment was provided above at paragraphs 17 to 32. The Sample only provides some typical examples of how different types of persons may be distinguished and the type of tax treatment that may be applied

to them. In all cases these distinctions and the treatment must be adjusted to local circumstances. However, in distinguishing between different types of entities, it is important to have one category of entity as a residual type to ensure that all types of entities are covered by the income tax. This is particularly important with respect to foreign entities, which may not be easy to classify according to local distinctions.

204. The residual type of entity under the Sample is "company", which at its broadest covers unincorporated associations and bodies of persons. By contrast, "partnership" is defined in terms of persons carrying on business jointly and "trust" in terms of a trustee holding assets. Partnerships and trusts are generally excluded from the definition of "company". However, to the extent possible, tax treatment should follow the substance of an activity and not the form in which it is conducted. It is towards this end that some trusts and partnerships are treated as companies. Under the Sample, "limited partnerships" and "unit trusts", as defined in section 105(2), are treated as companies.
205. Section 106 moves to particular types of persons involved in entities. These are of two basic types divided along the traditional distinction between ownership and management, i.e. "beneficiaries" and "managers". These terms are defined in section 106 including by way of sub-categorisation. "Beneficiary" is defined in terms of a person with an "interest" in an entity. This term is further defined by reference to a right to participate in income or capital of an entity. The form of the right is not relevant. Subcategories of "beneficiary" include "partners", beneficiaries of partnerships, and "shareholders", beneficiaries of companies. There is no separate term for the beneficiary of a trust.
206. "Manager" in relation to an entity is defined in section 106 in terms of participation in senior management decisions of the entity. Therefore, directors of a company will be considered managers of the company. The definition also includes some types of persons irrespective of such participation. These include partners, trustees, and owners of foreign branches. "Trustee" is defined in section 106 in broad terms to include any person with a fiduciary position that involves holding assets for the benefit of other persons or an object permitted by law. The inclusive part of the definition of "trustee" provides examples of arrangements that are considered trusts such as deceased estates, estates of incapacitated persons and insolvents, receiverships, and mortgagees in possession. As mentioned above at paragraph 204, the concept of "trustee" is central to the definition of "trust".
207. Section 107 deals with the important category of associated persons. Special rules apply to associated persons throughout the Sample, typically to apply arm's length treatment. By reason of their relationship, associated persons are often able to engage in tax reduction arrangements that independent persons would not. The definition of "associated persons" is very broad. Section 107(1) provides a general definition in terms of it being reasonable to expect that one person will act in accordance with the wishes of another. This is an objective test and it is not necessary that one person actually act in this manner, although that would be relevant under the test. Section 107(2) provides for specific inclusions in the concept of "associated persons", which broaden the general

definition. Individuals and relatives are presumed to be associated as are partners. This presumption can be rebutted by satisfying the tax administration that in the particular case the general test in section 107(1) would not be met. "Relatives" is defined in section 107(3) by reference to three generations of individuals from a common descendant, including by way of marriage or adoption.

208. The other inclusive heads of "associated persons" in section 107(2)(c) and (d) are not subject to rebuttal and the persons referred to are associated irrespective of whether the test in section 107(1) is met. The main head in this regard is section 107(2)(d), which has particularly broad application in determining who an entity is associated with. An entity is associated with each member of a group of associated persons that, e.g. together hold 50 percent of the entity in question. An entity can be a member of the group of associated persons and section 107(2)(d) may be triggered by the inclusion of an entity in the group under a previous application of that provision.
209. For example, entity A is owned 40 percent by Y and 60 percent by Z. Therefore, entity A and Z are associated. Entity B is owned 40 percent by entity A, 40 percent by X, and 20 percent by Z. Entity A and Z are a group of persons holding more than 50 percent of entity B. Therefore, by reason of multiple applications of section 107(2)(d)(i), entity A, entity B, and Z are all associated. Further, by reason of section 107(2)(d)(ii), all other associates of entity A or entity B (e.g. their subsidiaries) or of Z (e.g. subject to rebuttal Z's relatives or partners) all fall within the group of association and are considered associates of each other.
210. Persons are also distinguished on the basis of residence. Sections 109 and 110 provide tests for determining whether different types of persons are resident. Under section 108, if a person is not resident then the person is considered a non-resident. In some cases it is necessary to determine in which foreign country a non-resident person is considered resident. As mentioned above at paragraph 146, this might be the case in applying the country-by-country limitations to the use of foreign source losses and the calculation of foreign tax offsets. Section 108(4) adapts the tests in sections 109 and 110 for this purpose.
211. Section 109 determines when an individual is considered resident. The three tests in section 109(1) follow standard lines and require little discussion other than to emphasise again that they should be adjusted to suit local considerations. If one of these tests is met for a tax year, the individual will generally be considered resident for the whole year. Exceptions to this rule are found in section 109(3) and (4). If an individual who becomes a resident for the current tax year was not a resident in the previous tax year, the individual is only considered resident from the date the individual is first present domestically during the current year. If an individual is not a resident in the current tax year, the individual is only a resident for the previous tax year up to the date the individual is last present domestically during the previous year. Being resident during part only of a tax year has certain consequences regarding tax rates and the calculation of assessable income, discussed above at paragraph 23 with respect to section 5 and also see section 15. Section 109(6) also contains a definition of "temporarily resident" for

individuals. This is relevant to section 115(4), which effectively applies exemption with progression to the foreign source income of a temporarily resident individual.

212. Section 110 determines when different types of entities are considered resident. The tests for partnerships and companies follow standard lines, the latter incorporating both the place of establishment and centre of management and control tests. The tests for trusts also incorporate the place of establishment as well as residence of a trustee. Given the ease with which these tests for trusts can be avoided, a third test is added. If a resident person, with or without other persons, directs or may direct senior managerial decisions of a trust, the trust is considered resident. For example, a person who has power to remove or appoint trustees may be considered to be in such a position. Finally, a domestic branch of a non-resident person is considered a resident person. The treatment of foreign branches as persons and the inclusion of domestic branches of non-residents as resident persons ensure that domestic subsidiaries and domestic branches of non-residents are treated in a similar fashion, see further the discussion above at paragraphs 24 to 26. To further this similar treatment, domestic branches are also subject to a branch profits tax, see discussion above at paragraphs 30 to 32 and the discussion below at paragraphs 248 and 249.

## **Division II: Rules Applicable to Particular Types of Persons**

213. This Division is divided into six subdivisions each dealing with special rules that apply to particular types of persons identified in section 105. Subdivision A is devoted to individuals. The remaining subdivisions are devoted to different types of entity. Subdivisions B to E are devoted to the main types of entity, i.e. partnerships, trusts, companies, and foreign branches. These four subdivisions follow a similar format. Each begins with a section setting out the general principles applicable under the Sample to income derived and distributed by the entity in question. These general principles were discussed above at paragraphs 24 to 29. Each of these four types of entity is treated separately from their beneficiaries and managers in calculating income. In order to ensure this treatment, each of the initial sections of these subdivisions contains a number of common provisions that require some further comment.

214. The first of these common provisions, sections 120(3), 130(4), 140(3), and 145(4), seek to emphasize this separation by stating that amounts derived and costs incurred by an entity are treated as only derived or only incurred by the entity and no other person. This is intended to avoid the argument that, while an entity that has no separate legal existence at general law can be given such an existence for tax purposes, it will have no income. For example, it may be argued that the income of a partnership is only the income of the partners. The same argument may arise in the context of assets owned and liabilities owed by entities and a similar approach is adopted to overcome this argument in sections 120(4), 130(5), 140(4), and 145(5). Similar problems arise with respect to foreign income tax paid with respect to the income of an entity. Other countries may tax the entity, the managers, or the beneficiaries with respect to such

income. All foreign income tax paid with respect to an entity's income is treated as paid by the entity, see sections 120(5), 130(6), 140(5), and 145(6).

215. The final common provision in these introductory sections deals with the recognition of arrangements between entities and their managers and beneficiaries, see sections 120(6), 130(7), 140(6), and 145(7). As a general rule, these arrangements are recognised. So, for example, a partner may be an "employee" of a partnership if the partner falls within the definition of that term in section 345. Further, sales between a head office and a foreign branch and loans by a shareholder to a company will be recognised. However, all such arrangements will be subject to adjustment under the transfer pricing, income splitting, or general anti-avoidance rules in sections 62, 63, and 69. Many countries do not adopt this approach and will often ignore arrangements between an entity and its managers and beneficiaries. While this is again an issue that must be adjusted to local considerations, care should be taken to ensure consistent treatment of entities that can be used to derive income in a similar manner.
216. Because entities are treated as separate persons and their income is treated as their own, distributions or other allocation of entities' income potentially give rise to a second source of income, i.e. a source of income derived by the beneficiaries of the entity. As mentioned above at paragraphs 24 to 29, economic double taxation is generally avoided in the cases of partnerships, trusts, and resident's foreign branches but there is the potential for partial double taxation in the case of companies and domestic branches of non-residents. Nevertheless, in all cases there is a need to define this secondary tax base, i.e. the tax base of the beneficiaries with respect to their interest in an entity. This is typically the second issue addressed by Subdivisions B to E. These subdivisions then proceed to the taxation treatment of the beneficiaries when this secondary tax base is allocated to them. Finally, these subdivisions, other than Subdivision D dealing with companies, make certain adjustments to beneficiaries' interests in entities to ensure appropriate treatment under the transactional basis income tax.
217. Subdivision F deals with controlled foreign trusts and companies. It is only partly structured like the other subdivisions dealing with entities. This is because Subdivision F is essentially based on but varies the treatment that would otherwise result under Subdivisions C and D, which generally deal with trusts and companies, respectively. In essence, Subdivision F adjusts the rules in Subdivisions C and D so that they more closely resemble the rules in Subdivisions B and E, which generally deal with partnerships and foreign branches, respectively.

#### ***Subdivision A: Individuals***

218. This Subdivision is relatively short, containing three sections that are particularly applicable to individuals. Section 115 allows resident individuals to claim certain personal offsets. These offsets directly reduce income tax payable by an individual under the first head of charge in section 1(1). Any excess offset is not refundable and is lost if it cannot be used in the tax year in which it is claimed. This approach is used

rather than providing an exemption threshold in the tax rates applicable to resident individuals in section 5(1) and was discussed above at paragraph 19. Its purpose is the same as an exemption threshold, i.e. to remove taxation from a basic living amount. Ideally, this amount should be sufficient to meet the bare necessities of life.

219. Section 115 provides a basic personal offset to all resident individuals. It also provides certain additional personal offsets to resident individuals for their resident "dependants". "Dependant" is defined in section 345 and is also relevant to some of the terms used with respect to retirement savings under Division II of Part IV, discussed below at paragraphs 306 to 310. The additional personal offset for temporarily resident individuals with respect to their foreign source income under section 115(4) was discussed above at paragraph 211. Finally, under section 115(5) apportionment rules apply to individuals who are only resident for part of the tax year in question. These are consistent with those in sections 5(7), and 15(2), the former was discussed above at paragraph 23.
220. Section 116 provides individuals with an offset for medical costs incurred by the individual. A deduction would typically be denied for medical costs under section 25(1)(a) because they are personal in nature. However, as with the personal offset, the medical costs offset recognises that basic medical costs are a necessity of life. This is a highly political area where the approach to the issue will invariably depend on local considerations. For governments that provide comprehensive health services to their residents, this provision may be unnecessary. Again, section 116 provides just one possible approach to the issue. In particular, the approach offered assumes the lack of a comprehensive government run health service.
221. Section 116(1) permits an individual to claim an offset for "approved medical costs". This phrase is defined in section 116(5) by reference to the regulations. Which medical costs are considered to justify a reduction in income taxation is likely to be highly subjective to particular countries. "Medical costs" is defined in section 345 in conventional terms but includes the payment of premiums for medical insurance. An individual may claim the offset with respect to medical costs paid by the individual or a dependant of the individual. The extension to dependants is consistent with the additional personal offset available with respect to dependants under section 115. Under section 116(2), the medical costs offset is calculated by applying a rate to the medical costs. This rate should represent the extent to which the government wishes to subsidise health care under the income tax system and is likely to vary substantially from country to country. Where the government provides some sort of government funded health care, the level of this rate will determine the extent to which the government wishes to encourage the use of private health care.
222. The amount of the medical costs offset that an individual may claim for any tax year is capped under section 116(3). It is limited to a "reasonable medical insurance premium" the level of which must be set locally. The idea is that the government identifies a basic level of medical insurance and uses the premiums for that as the base to calculate the limit. This limit may work harshly against individuals who opt to not

have health insurance, i.e. who opt to self-insure. This is because medical costs for an individual tend to vary greatly from year to year. Where an individual incurs medical costs for which an offset is not available for a tax year, e.g. where they exceed the reasonable medical insurance premium selected, the excess may be carried forward and used in calculating the medical costs offset of the next tax year. This method of averaging is consistent with the approach applying to losses under section 33, discussed above at paragraph 92.

223. Section 117 identifies "taxable investment income" of a minor and, therefore, the income of a minor that is subject to tax at the highest marginal rate under section 5(4). The reasons for this treatment were discussed above at paragraph 22. There is a carve out under section 117(2) to prevent this treatment in the context of an incapacitated minor.

### ***Subdivision B: Partnerships***

224. Section 120(1) states the general principle that partnerships are not taxpaying subjects for the purposes of the first head of charge under section 1(1). They are, however, required to calculate their taxable income and, if served with a notice by the tax administration, required to file a return of income, see section 236. Any income or loss of a partnership is allocated to the partners, see section 120(2). Similar to resident's foreign branches but in contrast to companies, this allocation occurs irrespective of distribution. The tax base that is used for this allocation, i.e. the secondary tax base, is defined in section 121 and is similar but not the same as the tax base used to calculate a partnership's taxable income, i.e. the primary tax base. The rest of section 120 was discussed above at paragraphs 214 to 216.

225. The secondary tax base of partnerships is defined in section 121 in terms of "partnership income" or "partnership loss". As "partnership" is defined in section 105 in terms of a business, section 121 assumes that all income and losses of a partnership will be from a business, i.e. any other joint income or loss of persons will be allocated under section 61. Partnership income is assessable income of the partnership from a business calculated as though the partnership were a resident partnership. This is in order to ensure that partnership income includes world-wide income but does not include final withholding payments and exempt amounts. In particular, final withholding payments are taxed to partnerships under the third head of charge in section 1(1). Partnership income is calculated without reference to section 33. Because partnership losses are allocated to the partners, it is inappropriate to take them into account in calculating partnership income.

226. Partnership income or partnership loss is allocated to partners under section 122(1) according to each "partner's share". This term is defined in section 122(6)(a) in terms of the partner's percentage interest in income of the partnership under the partnership arrangement. Section 122(6)(b) provides an alternative test where the primary test is inappropriate. Section 122(1) makes separate reference to the tax year of the partnership

and the tax year of a partner. Issues arising where a partnership and a partner have different tax years were discussed above at paragraph 102. Importantly, the allocation to a partner only provides an inclusion or deduction in calculating the partner's income, i.e. it is not directly included or deducted in calculating the partner's assessable or taxable income. For example, this means that any allocated income may be further reduced by deductions claimed at the partner level such as with respect to interest on money borrowed to acquire an interest in a partnership.

227. Section 122(2) provides that amounts allocated to a partner retain their character in the hands of the partner, i.e. the character under the secondary tax base is determined according to the primary tax base. This allocation of individual amounts included or deducted in calculating the primary tax base, i.e. the partnership's income, is made proportionately to each partner's share. The proportionate approach goes some way to preventing abuse through the streaming of particular types of income, such as foreign income, to persons who can most efficiently use that income from a tax perspective, e.g. through use of foreign tax offsets claimed under section 200. Section 122(2) also provides a timing rule that the partner is treated as deriving or incurring amounts allocated at the end of the relevant tax year of the partnership. This is to ensure that the allocation under section 122 and the consequent adjustments to the incomings and outgoings for the partner's interest in the partnership under section 123 occur at the same time. Further, for administrative simplicity reasons it is felt more appropriate that the allocation and adjustment only be made once per year.

228. Section 122(3) proceeds to allocate tax considered paid by the partnership with respect to its income. This allocation is at the same time and on a similar basis as the allocation of partnership income and losses, i.e. proportionately according to each partner's share. Section 122(4) treats a partner as having paid partnership tax allocated to the partner and this in turn triggers an entitlement to, e.g. a foreign tax offset for partnership foreign income tax or a tax credit for domestic income tax withheld from payments to the partnership. In particular, a tax credit may be available under section 223 for tax paid by the partnership "as though tax were withheld from a payment to the partner." As discussed below at paragraphs 313 and 331, sections 200 and 223 ensure that any such offset or tax credit is included in calculating the partner's income, i.e. they ensure gross-up.

229. Section 122(5) provides a special rule applying to non-resident partners in resident partnerships. It first treats such a partner as having a domestic branch and then, e.g. allocates domestic source partnership income under section 122(1) to the branch and not the partner. The branch will be directly liable to pay tax with respect to this income, including by way of instalment. The branch's income will be further allocated to the non-resident partner under section 148. It may also be subject to branch profits tax under the second head of section 1(1).

230. Section 123(1) includes in the outgoings for a partner's interest in a partnership amounts allocated and included in calculating the income of the partner under section 122. This is in order to remove the potential for double taxation. This may occur where

partnership income is taxed to a partner but is retained by the partnership causing an increase in the value of the partner's interest in the partnership that is then sold giving rise to a taxable gain. For reasons mentioned above at paragraph 124 in the context of long-term contracts, this double taxation will only be temporary but the adjustment is incorporated because it is relatively simple in the case of partnerships. Note that adjustments to outgoings are also made under section 123 for amounts that are not allocated to partners under section 122, i.e. exempt amounts and final withholding payments. This ensures that, in the former case, preferences granted under the payments basis income tax are not washed out by the transactional basis income tax and, in the latter case, that double taxation is avoided by reason of doubling up of these two income taxes.

231. Section 123(2) makes adjustments to the incomings for a partner's interest in a partnership that reflect those in section 123(1). "Distributions" by partnerships to partners are treated as incomings for a partner, offsetting the outgoings granted under section 123(1) for allocated partnership income. "Distribution" by an entity is defined in section 165, discussed below at paragraphs 265 to 271. Further, a partner's share of non-deductible costs incurred by a partnership is included as incomings for the partner, e.g. consumption costs and excluded costs that are not deductible under section 25(1), discussed above at paragraphs 70 to 75. In this case, the inclusion is to ensure that a deduction is not effectively available for these costs under the transactional basis income tax (their non-deductibility will have increased partnership income allocated to partners and, therefore, the outgoings for the partners under section 123(1)). This rule does not apply where the deduction is only deferred and will otherwise be recognised for the partnership under the transactional basis income tax, i.e. it does not apply to outgoings for partnership assets and liabilities.

### ***Subdivision C: Trusts***

232. Trusts are treated differently from partnerships under the Sample. The general treatment of trusts is outlined in section 130. They are directly liable for tax under the first head of charge under section 1(1) with respect to their taxable income. Further, the income of a trust may be allocated and taxed to the beneficiaries of the trust in certain circumstances, see discussion of section 133 below at paragraphs 235 to 238. This allocation is a hybrid between the treatment of partnerships and resident's foreign branches and that of companies. It may occur without distribution but may be triggered by distribution. For the purposes of this allocation, it is necessary to define the secondary tax base for trusts and this is done through the concept of "attributable income" in section 131. In order to avoid double taxation of trust income, beneficiaries are also allocated any tax paid by a trust with respect to income allocated to the beneficiaries, see discussion of section 133 below at paragraph 239. The remainder of section 130 is either self-explanatory or was discussed above at paragraphs 214 to 216.

233. "Attributable income" of a trust is defined in section 131 in similar terms as "partnership income" in section 121. The discussion of "partnership income" at

paragraph 225 is also relevant to the concept of "attributable income". The major difference between these two concepts is that losses of a trust may not be allocated to beneficiaries of the trust. This treatment is similar to the treatment of shareholders in companies. Losses may, however, be used at the trust level in accordance with section 33.

234. Section 132 contains a special rule only applicable to trusts. In limited circumstances, it enables a trust to be treated in a similar manner as a partnership, i.e. not subject to income tax with respect to what would otherwise be its taxable income. This is achieved by granting a trust a deduction with respect to certain entitlements of a resident beneficiary. The entitlement must be a "vested right" to income or an amount included in calculating the income of the trust and exist during the tax year in which the trust derives the income or amount. "Vested right" is not defined and so will take its ordinary meaning. It generally means a right that is not subject to contingency. Where section 132 applies, the beneficiary rather than the trust will be liable to pay tax with respect to the income or amount by reason of allocation under section 133(2), discussed in the next paragraph. This payment of tax includes by way of instalment under section 230. In order that the payment of instalments may not be deferred, section 132 only applies where the trust and the beneficiary have the same tax year. The main benefit of section 132 is that tax is levied at the beneficiary's marginal rate instead of at the trust rate. The latter is equal to the highest marginal rate and its application may result in a claim by a beneficiary (to whom attributable income of a trust is allocated) for a refund of excess tax credits under section 301.
235. Section 133 deals with the taxation of beneficiaries of trusts and contains a number of provisions that are analogous to those in section 122, discussed above at paragraphs 226 to 228. However, unlike section 122, section 133 has two provisions that may allocate attributable income of a trust to a beneficiary. The dominant allocation provision is section 133(2). It provides for the allocation of parts of the attributable income of a trust to the trust's beneficiaries in certain conditions. As with partners, the inclusion is in calculating the beneficiary's income and not directly in assessable or taxable income. There are three heads in section 133(2) under which allocation may occur. The first is where section 132 applies, i.e. where the trust is entitled to a deduction with respect to a vested right of a beneficiary.
236. The second head of allocation under section 133(2) is less stringent. It applies where a beneficiary is "entitled" to part of or an amount included in calculating the attributable income of a trust. "Entitled" is not defined. It will take its technical meaning under the law of trusts or otherwise its general meaning. The third head of allocation under section 133(2) applies where the attributable income or amount is actually distributed to a beneficiary. "Distribution" of an entity is defined in section 165 and is discussed below at paragraphs 265 to 271. With respect to both these heads of section 133(2), the entitlement must exist or the distribution must be made either during the trust's tax year to which the attributable income relates or within 30 days of its end. An entitlement or distribution occurring after this time does not result in allocation under section 133(2).

Unless the trust in question is a non-resident trust and allocation occurs under section 133(3), this means that any tax levied at the trust level is a final tax.

237. Allocation under section 133(3) is not subject to the time limitation in section 133(2). However, section 133(3) only applies to a trust's attributable income of a year during which the trust was a non-resident trust. The reason for the difference in treatment is that non-resident trusts are not taxed on their world-wide income and when their income accrues to the benefit of a resident beneficiary, the country of residence will not be sure that an appropriate level of taxation has been suffered by the income. Shareholders of non-resident companies are treated in a similar manner with respect to dividends received from such companies. The heads of allocation under section 133(3) correspond to the second and third heads under section 133(2).
238. Section 133(4) applies a pass through of characterisation on allocation under section 133(2) similar to that in section 122(2)(a) discussed above at paragraph 227. By contrast, allocation of attributable income of a non-resident trust under section 133(3), i.e. after the year in which the attributable income is derived by the trust, does not result in the pass through of characterisation treatment. Rather, the income or amounts allocated are treated as derived by the beneficiary from an investment. Section 133(5) deals with the timing of allocation. This timing is different from that applying in the context of partnerships under section 122(2)(b), discussed above at paragraph 227. This is because the adjustments to incomings and outgoings with respect to an interest in a partnership to alleviate the potential for temporary double taxation as a result of allocation, discussed above at paragraph 230, are not made in the context of trusts. In the case of trusts, as in the case of companies, this adjustment is problematic because it is more likely that income allocated to one beneficiary may actually be distributed to another.
239. Sections 133(6) and (7) are similar to sections 122(3) and (4) and so the discussion above at paragraph 228 in the context of partnerships is relevant. In the case of trusts, however, there is greater scope for the type of tax that may be allocated to beneficiaries. Unlike partnerships, trusts are taxpaying entities and so income tax levied directly on trusts by way of withholding, instalment, or assessment as well as foreign income tax may be allocated to beneficiaries.
240. Sections 134 and 135 are designed to maximise the benefit that trusts of incapacitated individuals, estates of deceased individuals, and beneficiaries of both may derive from section 132. The intention is that, more often than not, the income of these trusts will be allocated and taxed to the beneficiaries and not the trust. In the case of trusts of incapacitated individuals, the trustee will still be liable for tax payable by the incapacitated individual by reason of section 281. However, that tax will be payable at the individual's rate and not that applicable to the trust.
241. As mentioned above at paragraph 238, the adjustments made to the interests of partners in partnerships by section 123 are not made in the context of trusts. However, like section 123, section 136 seeks to prevent the wash out under the transactional basis

income tax of exemptions granted under the payments basis income tax. Further, it seeks to prevent the double taxation that may occur were both of these income taxes to apply to final withholding payments and the attributable income of trusts. This wash out or double taxation may occur if the distribution of exempt amounts, final withholding payments, or attributable income of trusts were considered incomings for a beneficiary's interest in a trust. By contrast, this wash out and double taxation may occur in the context of companies, discussed below at paragraphs 244 to 246.

#### ***Subdivision D: Companies***

242. Like trusts, companies are taxpaying subjects, see section 140(1). However, unlike partnerships, trusts, and resident's foreign branches, the income of a company will generally only be allocated to shareholders where a company distributes a dividend. Further, dividends of resident companies are taxed by means of a final withholding tax, discussed above at paragraphs 28 and 29. By contrast, dividends of non-resident companies are fully taxable in the hands of residents for the reasons discussed above at paragraph 237 in the context of trusts. In neither case, however, is tax paid by the company with respect to income that is used to distribute dividends allocated to shareholders. An exception applies in the context of controlled foreign companies, discussed below at paragraphs 260 to 262. The remaining provisions in section 140 were discussed above at paragraphs 214 to 216.
243. The secondary tax base for corporate income is "dividends". This term is defined in section 141 in terms of a "distribution" by a company that is not a "repayment of capital". Both of these terms are defined in section 165 and discussed below at paragraphs 265 to 271. Unlike the secondary tax base for partnerships, trusts, and resident's foreign branches, the definition of dividend will include distributions from amounts that are either exempt or final withholding payments in the hands of the distributing company.
244. Section 142 deals with the taxation of shareholders. As mentioned at paragraph 242, shareholders are generally taxed with respect to dividends either by final withholding tax (resident companies) or by assessment (non-resident companies). Subdivision D, unlike Subdivisions B, C, and E, does not provide for specific adjustments to the incomings for shares in companies. This is for two reasons. Firstly, as discussed at paragraph 238, in the case of trusts and companies there is no effort to seek to remove the temporary double taxation that is addressed in the context of long-term contracts, partnerships, and resident's foreign branches. Secondly, double taxation of corporate income under the payments basis income tax is intended. As mentioned at paragraph 241, this also means the wash out of exemptions granted to a company and the double taxation of final withholding payments received by a company, i.e. on distribution. At worst, this wash out or double taxation is limited to final withholding tax applied to dividends.
245. However, where the shareholder is also a company, the distribution of corporate income, exempt amounts, and final withholding payments to the corporate shareholder

will give rise to yet another level of final withholding tax when the corporate shareholder redistributes these amounts. Where there is a chain of corporate shareholdings there is the potential for the final withholding tax on dividends to cascade down the chain. To ameliorate this unintended effect, section 142(2) provides that certain dividends distributed between resident companies are exempt from tax, i.e. exempt from final withholding tax. Essentially, the recipient company must hold 25 percent or more of the distributing company.

246. Section 142(3) limits the exemption in section 142(2). It is not available where the shareholder is an "exempt organisation". This term is defined in section 20 and was discussed above at paragraph 68. In this case, a dividend will be exempt only if it falls within the organisation's exemption in section 20. Section 142(2) also does not apply to dividends distributed on redeemable shares. This is because these types of shares are highly fungible with debt. Companies in a loss position may essentially borrow funds through the issue of redeemable shares. The deduction usually associated with interest payments on debt is of little use to a company with existing losses. By contrast, if the exemption in section 142(2) applied to redeemable shares the effective lender may be exempt on the effective interest received in the form of dividends, when the lender would be taxable if interest were received. This would, in essence, provide a loss company with a mechanism for passing the benefit of its losses to a lender.

#### ***Subdivision E: Foreigner's Symmetrican Branches and Other Foreign Branches***

247. Whether foreign branches, i.e. branches situated outside their owner's country of residence, are treated under the Sample as taxpaying subjects depends on where they are located. Section 145(1)(a) says that foreign branches that are situated domestically are taxed with respect to their income but the owner is not, i.e. the owner is exempt with respect to such income. These branches are also subject to branch profits tax in order to provide a similar treatment to subsidiaries owned by non-residents, see section 145(2) and the discussion above at paragraph 32. By contrast, section 145(1)(b) says that other foreign branches, i.e. those situated in foreign countries, are not taxpaying subjects, rather the owner is taxed with respect to any taxable income of the branch. In this case, the income or loss of the foreign branch is allocated to the owner, see section 145(3). By contrast, only the income of a domestic branch of a non-resident is allocated to the non-resident and not exceeding the branch's repatriated income. In either case, the allocation is made in much the same manner as under Subdivision B applying to partnerships. The remaining provisions of section 145 were discussed above at paragraphs 214 to 216.

248. The second head of income tax in section 1(1) is the branch profits tax, discussed above at paragraphs 32 and 212. Section 146 calculates the tax base for this head of income tax in terms of "repatriated income". Unlike branch profits taxes implemented by some countries that subject all profits of a branch to the tax, the approach in the Sample is to tax only those profits that have left the country. "Repatriated income" of a foreign branch for a tax year is defined in section 146 by reference to "distributions"

made during the year that are not "repayments of capital". Both of these terms are defined in section 165 and discussed below at paragraphs 265 to 271.

249. The definition of "repatriated income" is similar to the definition of "dividends" in the context of companies and the discussion above at paragraph 243 of section 141 is relevant. One difference is that in the case of foreign branches the secondary tax base for branch income differs depending on the location of the foreign branch. That is, in the case of domestic branches of non-residents the secondary tax base is repatriated income and in the case of branches situated in a foreign country it is the income or loss of the branch calculated under section 147. As mentioned above at paragraph 32, this treatment of domestic foreign branches is similar to resident subsidiaries of non-residents. One difference is that in the case of subsidiaries income tax on the secondary tax base, i.e. dividends, is collected by way of final withholding tax under Division II of Part V. By contrast, income tax on the secondary tax base of domestic branches is collected from the branch through the instalment system under Division III of Part V.
250. Section 147 calculates the foreign branch income or loss of a foreign branch in a similar manner as partnership income or loss is calculated under section 121. The discussion above at paragraph 225 of section 121 is also relevant to section 147. One difference is that, as mentioned above at paragraph 247, losses of a domestic branch of a non-resident are not allocated to the non-resident. Therefore, in calculating the foreign branch income of such a branch losses may be deducted under section 33.
251. The application of section 148 to foreign branches and their owners substantially reflects the application of section 122 to partnerships and their partners. The discussion above at paragraphs 226 to 228 of section 122 is also relevant to section 148. Section 148 is simpler than section 122 in that there is no issue of allocating the income or loss between partners. The income or loss of a foreign branch is all allocated to its owner. As mentioned above at paragraph 247, a difference from the partnership provisions is that in the case of a domestic branch of a non-resident, foreign branch income is allocated to the non-resident only to the extent of repatriated income of the branch. Further, losses of the branch are not allocated. Section 148(4) ensures that branch profits tax paid under the second head of income tax in section 1(1) by such a branch is allocated to the non-resident owner together with other income tax paid by the branch. The reason for allocating income and tax to such an owner when the owner has no direct tax liability with respect to the branch income is that this tax may be further allocated to other persons. For example, where the non-resident owner is a controlled foreign trust or company the further allocation may be to a beneficiary or associated shareholder.
252. Section 149 makes adjustments to the outgoings and incomings for an owner's interest in a foreign branch. They are the same adjustments that are made in the context of interests in partnerships under section 123. Therefore, the discussion above at paragraphs 230 and 231 of section 123 is also relevant to section 149.

#### ***Subdivision F: Controlled Foreign Trusts and Companies***

253. This Subdivision differs from Subdivisions B to E in that it amends the treatment relating to certain trusts and companies under Subdivisions C and D. The approach is to treat these trusts and companies as distributing their unallocated income at the end of each tax year. This causes a treatment similar to, but not the same as, that applying to the income of partnerships and resident's foreign branches. The reason for the Subdivision is to prevent deferral of taxation by residents with respect to their foreign source income by holding funds in non-resident trusts and companies. These rules are typically complex and whether they should be adopted or not will depend on local considerations. These rules may also be adopted in a simplified but less precise form. For example, Subdivisions C and D may be entirely overridden, all income of the trust or company may be allocated to beneficiaries and shareholders at the end of a tax year, and all distributions made during the year exempted.
254. The Subdivision applies to "controlled foreign trusts" and "controlled foreign companies", phrases that are defined in section 105. These are non-resident trusts and companies in which an "associated" resident person holds an interest. "Associated persons" is defined in section 107 and was discussed above at paragraphs 207 to 209. This interest can be held directly or indirectly through other non-resident entities. For example, Company A and Trust B are non-residents and Z is a resident. Company A holds 51 percent of Trust B and Z holds 51 percent of Company A. By reason of section 107(2)(d)(i), Company A and Z are associates. Further, Z holds a direct interest in Company A and so Company A is a controlled foreign company. Further, by reason of section 107(2)(d)(i), Company A and Trust B are associates and, by reason of section 107(2)(d)(ii), because Company A is also associated with Z, Trust B and Z are also associates. As Z holds an indirect interest in Trust B, i.e. through Company A, Trust B is a controlled foreign trust.
255. The definition in section 105 is further extended where this association with the non-resident company or trust would be met if not more than five residents were associated. For example, V, W, X, Y, and Z are non-associated residents that each hold 12 percent of Company C, a non-resident company. If V, W, X, Y, and Z were associated, they would each be associated with Company C by reason of their aggregated holding in the company exceeding 50 percent, see section 107(2)(d)(i). Therefore, as they hold an interest in Company C, Company C is a controlled foreign company.
256. Section 156(1) defines "unallocated income" of a controlled foreign trust or company. In the case of a trust, this is the trust's "attributable income" under section 131 for a tax year less the amount of that income that is allocated under section 133(2) for the year. The discussion above at paragraphs 233, 235, and 236 is relevant in this respect. The "unallocated income" of a controlled foreign company is also its "attributable income" but this time less dividends distributed during the year. "Attributable income" of a controlled foreign company is defined in section 156(2). It is similar to the definition of that term in the case of trusts in section 131 and the discussion above at paragraph 233 is relevant.

257. Section 157(1) provides for the distribution of unallocated income of a controlled foreign trust or company. The provision only applies to a trust or company that is a controlled foreign trust or company at the end of the tax year in question. Any attempt by a resident person to divest themselves of an interest in a non-resident trust or company just before the end of the year in order to avoid the allocation under this provision may be thwarted by section 69, the general anti-avoidance rule. This may particularly be the case if the interest is re-acquired shortly after the end of the year. Unallocated income is generally treated by section 157(1) as distributed in accordance with beneficiaries rights to the income. In some cases this allocation may be difficult, e.g. in the case of a discretionary trust or a company with different classes of shares. In this case, the tax administration is given power to provide an allocation.
258. The amount treated as distributed to the beneficiaries will be included in calculating the income of the beneficiaries. In the case of resident beneficiaries, this will be assessable income, e.g. under section 18 including by way of section 133(2)(c) or (3)(b), and, therefore, may be taxed under the first head of income tax in section 1(1). Importantly, where the beneficiary is a partnership, trust, or foreign branch, the distribution will be included in calculating the entity's partnership income, attributable income, or foreign branch income, respectively. Similarly, if the beneficiary is also a controlled foreign trust or company, the distribution will be included in calculating the unallocated income of the trust or company. Returning to the example above at paragraph 254, assume that Company A and Trust B do not have any distributions or allocations for the tax year in question. In this case, section 157(1) will allocate 51 percent of the unallocated income of Trust B to Company A, which will be included in calculating the unallocated income of Company A. 51 percent of the unallocated income of Company A will be allocated to Z. The effect is to allocate 26% of the unallocated income of Trust B to Z.
259. Income that is treated as distributed ("allocated") in one year may actually be distributed in a future year. If both the allocation and the distribution are taxed, there is double taxation. Section 157(2) seeks to relieve this double taxation by granting a beneficiary a deduction for amounts allocated under section 157(1). The deduction is only permitted in a tax year after the tax year of allocation and only to the extent of allocations under the general provisions applicable to trusts and companies for the future year, e.g. allocation under section 133(3) and distributions of dividends. The exception is that in the case of a controlled foreign trust, the deduction can be used in the year of allocation under section 157(1) to the extent of allocations made under section 133(3) for that year. This allocation is similar to dividends distributed by companies out of prior years' attributable income. However, under section 156(1), these distributions reduce a company's unallocated income but allocations under section 133(3) do not reduce the unallocated income of a trust.
260. Section 157(3) applies to controlled foreign companies in a similar manner as sections 122(2), 133(4), and 148(2) apply to partnerships, trusts, and foreign branches, respectively. The above discussion of those provisions at paragraphs 227, 238, and 251 is relevant to section 157(3). Section 157(3) only applies to controlled foreign

companies whereas section 133(4)(a) will apply to amounts treated as distributed by controlled foreign trusts by section 157(1). Unlike, Subdivisions B, C, and E, Subdivision D does not provide for the pass through of characterisation on the distribution of dividends by companies. That is, dividends typically have the character of dividends and do not take their character from the income of the company from which they may be considered distributed. Section 157(3) provides an exception to this rule. The main reason for this is to facilitate underlying foreign tax relief, relief that is often automatically available in the case of partnerships, trusts, and foreign branches, see further the discussion below at paragraphs 311 to 316.

261. Section 157(3) applies to all dividends distributed by a controlled foreign company and not just those treated as distributed by section 157(1). However, in order to receive the pass through of characterisation treatment, the recipient of the dividend must be an associate of the company. This provision does not contain the additional requirement that the recipient also be a company, as is often found in underlying foreign tax relief systems in practice. In the context of what is close to full dividend relief for shareholder and corporate income taxes under the Sample, see the discussion above at paragraphs 28 and 29, this restriction does not seem appropriate. Further, there does not seem to be any situation in which this approach can be abused to reduce taxation. If countries wish to restrict underlying foreign tax relief only to resident companies, it is a relatively simple matter to add this requirement to section 157(3).

262. Sections 157(4) and (5) correspond to sections 122(3) and (4), 133(6) and (7), and 148(3) and (5) applying in the cases of partnerships, trusts, and foreign branches, respectively. The above discussion of those provisions at paragraphs 228, 239, and 251 is relevant to section 157(4) and (5). Section 157(4) and (5) also only apply to controlled foreign companies. Section 133(6) and (7) will apply in the context of controlled foreign trusts. Section 157(4) and (5) allocate tax paid or treated as paid by a controlled foreign company to distributions to which section 157(3) applies. The effect is that shareholders associated with a controlled foreign company will be proportionately allocated tax of the company with distributions of the company. As such tax is treated as paid by an associated shareholder, the shareholder will be entitled to foreign tax offsets under section 200 with respect to the tax. Section 157(3), (4), and (5) may have an extended operation by reason of section 175(3). The effect is that domestic income tax paid by a resident company is allocated to non-resident associated shareholders with dividends received from the company. If such a shareholder is also an entity, the domestic tax may be further allocated (as foreign income tax) and, if allocated to a resident beneficiary, the beneficiary may claim foreign tax offsets for the underlying domestic tax.

263. Finally, section 158 supplements the treatment of outgoings and incomings for interests in trusts and companies discussed above at paragraphs 241 and 244. It is targeted at removing the potential temporary double taxation towards which section 123 and 149 are targeted in the context of partnerships and foreign branches, respectively. To that extent, the above discussion of those provisions at paragraphs 230, 231, and 252 is relevant.

### **Division III: General Provisions Applicable to Entities**

264. This Division contains a number of provisions that apply commonly to partnerships, trusts, companies, and foreign branches. The Division is predominantly directed towards issues arising as a result of the potential overlap of the payments basis income tax and the transactional basis income tax. This is a complex area because entities effectively create two levels of transactional basis income tax, a direct one at the entity level and an indirect one with respect to interests in entities held at the beneficiary level.
265. Section 165(1) begins by defining the central concept of "distribution" by an entity. This definition is particularly important with respect to the taxation of entities and their beneficiaries. Distributions are often included in calculating income of beneficiaries under the payments basis income tax, e.g. by section 18(2)(a) and 133(2) and (3) with respect to companies and trusts, respectively. They are also taken into account under the transactional basis income tax, e.g. by sections 123 and 149 with respect to partnerships and foreign branches, respectively.
266. "Distribution" is defined in terms of a "payment" by an entity to a beneficiary. "Payment" is defined in section 41, see above discussion at paragraphs 103 and 104. "Distribution" potentially includes any payment by an entity to a beneficiary irrespective of the capacity in which the beneficiary receives the payment, e.g. whether received as beneficiary, employee, purchaser, or debt holder. Given the broad definition of "payment", the definition of "distribution" is very broad but is subject to exclusions. A payment by an entity to a beneficiary is not a distribution to the extent that the beneficiary makes a return payment of an equal amount. For example, to the extent that a beneficiary pays market value for goods sold by the entity, the transfer of the goods by the entity is not a distribution. Further, to the extent that the payment is, otherwise than as a distribution, included in calculating the income of a beneficiary it is not a distribution by the entity. The same is true where the payment is a final withholding payment of the beneficiary.
267. Section 165(2) sub-categorises distributions by entities. These sub-categories often result in differing tax consequences. Under section 165(3), a distribution can only be a distribution of profits or a repayment of capital if it effectively reduces the distributing entity's resources. This means that these types of distributions will typically involve payments under the first limb of the definition of "payment" in section 41 but may involve a payment under the second limb of that definition. Section 165(4) then contains a profits-first rule. To the extent that the market value of an entity's assets exceeds the market value of its liabilities and capital contributions, a distribution of this type is a distribution of profits. To the extent there is no such excess, a distribution of this type is a repayment of capital. This general profits-first rule is used to minimise the potential for tax arbitrage, e.g. by entities streaming repayments of capital to taxable persons and distributions of profits to exempt persons. Often commercial law adopts a

profits-first rule, although usually only for companies. Whether this tax law profits-first rule is necessary should be assessed according to local considerations such as these.

268. Section 165(5) contains an exception to the profits-first rule in certain cases of termination of interests in entities including buy-backs. The exception only applies where distributions made in these circumstances are not referable to a share of profits of the entity. Further, the entity must terminate sufficient of the beneficiary's interest in the entity that after the termination the beneficiary is no longer an "associate" of the entity. "Associate" is defined in section 107 and discussed above at paragraphs 207 to 209. This means that it is not necessarily sufficient for the beneficiary to part with all their interests in the entity. The beneficiary must also sever all substantial connections with the entity including, e.g. any indirect holdings and holdings of relatives. Where these conditions are met, the profits-first rule is replaced with a rule considering the distribution as proportionately a distribution of profits and a repayment of capital. For example, this provision will apply when entities are liquidated.
269. In order to balance the broad definition of distribution of profits, section 165(6) contains a broad definition of "capital contribution". Under section 165(4), capital contributions effectively reduce the amount of distributions considered distributions of profits and increases those considered a repayment of capital. Reflecting section 165(1), a "capital contribution" is potentially any payment under the first or second limb of the definition of "payment" in section 41, discussed above at paragraphs 103 and 104, made by a beneficiary or potential beneficiary to an entity. The exceptions are to the extent that the entity makes a return payment to the beneficiary or the payment is an exempt amount, final withholding payment, or included in calculating the entity's income. Despite the broad definition, some informal value transfers to an entity will not be a capital contribution. An example is a gift to an entity that is made "in respect of" a business or investment of the entity, which must be included in calculating the entity's income under section 17(2)(f) or 18(2)(e). These provisions do not apply in the case of gifts by associates of an entity, the most likely type of beneficiary to make a gift to an entity. Such gifts by such a beneficiary will be treated as a capital contribution. Further, if the "in respect of" nexus is not met, a gift to an entity by a beneficiary will be a capital contribution in any case. Capitalisations of profits are also not a capital contribution and the distribution of capitalised profits by an entity will be a distribution of profits.
270. Section 166 is a short provision setting out the treatment of an entity with respect to capital contributions to and distributions by the entity. The approach under the Sample is, from the perspective of an entity, to ignore interests in the entity. It would be possible to set up a consistent treatment, particularly under the transactional basis income tax, by treating interests in entities as liabilities of the entity. This treatment would, perhaps, be closer to economic reality. However, it is not an approach used in practice and is not used in the Sample. Accordingly, the definition of "liability" in section 78 specifically excludes an entity's rights and obligations with respect to an interest of a beneficiary in the entity.

271. Any distribution of an entity that is not a distribution of profits or a repayment of capital is a "distribution of a collateral benefit", see section 165(7). These distributions will typically consist of payments under the third and fourth limbs of the definition of "payment" in section 41, discussed above at paragraphs 103 and 104. The effect of distributions of this type is to cause an entity to not derive income but, rather, provide a benefit directly to the beneficiary, i.e. the distribution to the beneficiary represents notional income of the entity. For example, a company may have a property available for rent but permits a shareholder to stay in it for free. There are two approaches to the taxation of this type of benefit. One is the same as is used in the context of employee fringe benefits. The notional income of the company may be ignored and the benefit fully included in calculating the income of the beneficiary.
272. This approach appears inconsistent with taxing corporate income twice under the Sample, i.e. once to the company and a second time by way of final withholding tax on distribution. The alternate approach is to include the notional income in calculating the income of the entity and otherwise treat the distribution of a collateral benefit in the same manner as any other distribution of profits. This is the approach taken in the Sample under section 167(1). This issue could also be addressed through an equalisation tax by requiring entities to match distributions with taxed profits and to the extent they cannot impose a make-up tax. However, an equalisation tax will have other effects. It may also tax distributions of unrealised gains and wash out other preferences such as direct exemptions and foreign tax relief. This treatment is inconsistent with the treatment of income derived directly by individuals and has been avoided in the Sample on that basis. A more principled approach to the quasi-realisation of unrealised gains, e.g. through borrowing, was discussed above at paragraph 174.
273. Nevertheless, section 167(1) does create some inconsistency with the treatment of individuals. Individuals are not taxed with respect to notional income, e.g. notional rent is not allocated under the Sample to individuals who live in their own homes. In the context of an individual, this is consistent with the basic approach under the Sample of not taxing wealth created unless it is paid for by a third party, see discussion above at paragraph 107. In the context of an entity, it may be argued that the entity is being paid for wealth created that is represented by distributions of collateral benefits, i.e. the beneficiaries pay in the form of allowing the entity to use their capital. Even if the entity is looked through, often it will be a group of persons managing and owning the entity that will be receiving the payment in the form of the use of capital. In these circumstances, the taxation of the notional income to the entity may be justified.
274. While this justification for taxation appears convincing in the case of widely held entities, it is less so in the case of closely held entities, particularly those acting in a passive manner. In this case, as the beneficiary may have conducted the passive activity directly, to tax the entity's notional income but not to tax if the beneficiary conducts the activity is to prefer form over substance. To this end, section 167(2) adopts a limited exception to section 167(1). The exception only applies to entities that are closely held by individuals and where the collateral benefit is provided outside the course of a business of the entity. Similar to the case of an individual in the same situation,

deductions are denied for amounts to the extent that they relate to the provision of the collateral benefit. For example, this exception may apply where a deceased individual places the family home in trust and the surviving spouse is permitted to live in the home rent free. By reason of section 167(2), the notional rent will not be taxable to the trust but the trust cannot claim deductions with respect to the home, e.g. rates and utilities.

275. Section 168 essentially applies the market value rules in sections 94(1) and (4) and 95 to dealings between entities and their beneficiaries. In this context, the above discussion of those sections at paragraphs 189 and 194 is relevant. The main difference between section 94(1) and (4) and section 168(1) and (2) is that under the latter provisions the transferor may incur a loss on the transfer. Where the entity and the beneficiary are associates, section 94(1) and (4) will override section 168(1) and (2) to deny any such loss. Section 168 only applies with respect to the transactional basis income tax. A transfer of an asset or liability between an entity and a beneficiary may give rise to a gain or loss from the realisation but may also result in a distribution by the entity or a capital contribution to the entity, e.g. where excessive or inadequate consideration is provided for the transfer.
276. Section 168(4) expressly excludes section 168 from applying to dealings in interests in entities between the entity and a beneficiary. The issuing of interests in entities is governed by section 169. It also applies to the transfer by an entity of an interest in itself, e.g. treasury stock. The general approach in section 169(1) is consistent with section 168 in applying a market value rule to the new beneficiary. The only circumstances in which a person is likely to acquire an interest in an entity from the entity for other than market value is where the person either already holds an interest in the entity or where the person is an associate of the entity. Where market value is not paid, there is an effective value shift either to or from the existing interests in the entity, except in some circumstances outlined in section 169(2). Such a value shift may be abusive where it is to or from a person associated with the entity. Value shifts of this type are dealt with in sections 173 and 174 and are discussed below at paragraphs 289 to 295. The market value rule in section 169(1) is consistent with these rules.
277. Section 169(2) and (3) apply an exception to the market value rule in section 169(1). They apply where the beneficiary already holds an interest in the entity, the new interest is issued or transferred in respect of the existing interest, and there is a value shift between the two interests. They do not apply where there is an effective value shift between interests of different beneficiaries of the entity. In particular, section 169(2) applies to a proportionate bonus issue to all beneficiaries in an entity. It also applies where the difference between the amount paid by a beneficiary for the new interest and the market value of the interest is balanced by an opposite change in value of the beneficiary's existing interest. Where section 169(2) applies, section 169(3) substitutes the market value rule with a rule that spreads the net outgoings for the old and new interests over both interests according to their market value.
278. The cancellation of an interest in an entity or the transfer of such an interest to the entity, e.g. in the case of a buy back, typically gives rise to both payments basis and

transactional basis income tax consequences. Any payment by the entity to the beneficiary for the cancellation or transfer will be a distribution by the entity. Any part of this distribution that is not a repayment of capital may be subject to payments basis income tax treatment, depending on the type of entity involved. Any part that is a repayment of capital is subject to transactional basis income tax treatment. The extent to which such a distribution is a repayment of capital is determined under section 165, discussed above at paragraphs 265 to 269. The quantity of such a distribution is typically determined in accordance with section 55. Section 170(1) provides an exception to this approach where the entity and the beneficiary whose interest is cancelled or transferred are associates. In this case the beneficiary is treated as receiving a market value distribution for parting with the interest in the entity. This is consistent with the approach in sections 94 and 95. Section 95 would not apply in this case because section 78 specifically excludes an entity's obligations with respect to an interest in the entity from the definition of "liability".

279. Where an entity purchases an interest in itself on a recognised stock exchange, section 170(2) provides an exception to the combination payments basis and transactional basis income tax treatment discussed in the last paragraph. The reason for this exception is that beneficiaries selling on the stock exchange will typically be subject to transactional basis income tax treatment only with respect to amounts derived for the sale. Further, due to the anonymity of sales in the ordinary course of business on a stock exchange, a beneficiary will not know that it is the entity that is buying the interest. Section 170(2) seeks to ensure that a beneficiary has the same tax consequences in these circumstances irrespective of who is the buyer. This rule may not be necessary for countries that do not permit entities to buy interests in themselves.
280. Section 170(2) effectively provides the selling beneficiary with transactional basis income tax treatment only. The entity is then treated as the holder of the interest in itself and cancelling that interest for a payment equal to the one made to the beneficiary for the interest. This deemed payment would be divided into a profits portion and a repayment of capital portion calculated in accordance with section 165(5). The profits portion may be subject to, e.g. dividend withholding tax. The capital portion will be treated as received in respect of the cancellation of the interest. This may result in a loss for the entity from the realisation of the interest. The overall effect of section 170(2) is similar to that which would have applied to the beneficiary if both the payments basis and transactional basis income taxes were applied as usual. The difference is that the entity may realise a loss that is offset by the beneficiary realising a smaller loss or realising a gain from the sale.
281. Sections 33(1)(c), 94, and 200(3)(b) permit, in limited circumstances, the direct transfer of tax attributes to and from entities, see discussion above at paragraphs 93 to 95 and 189 to 193 and below at paragraph 316. As mentioned at paragraph 42, this is essentially an issue of looking through the form in which a business or investment is held and looking to economic substance. Section 171 is of an opposite nature in seeking to prevent an indirect transfer of tax attributes of an entity to persons who do not own or are not commonly owned with the entity. A provision of this nature is recommended in

order to prevent tax arbitrage irrespective of whether the corresponding provisions are implemented to permit the direct transfer of entity tax attributes. Section 171(1) prevents the carry forward of tax attributes under the transactional basis income tax. It treats an entity as realising all its assets and liabilities where there is a change of 50 percent or more in the underlying ownership of the entity within a three year period. This level of underlying ownership is consistent with that required for the direct transfer of tax attributes to associates. Section 90, discussed above at paragraph 185, will apply a market value rule to the realisation. The result is that the entity will realise any previously unrealised gains and losses just before the change. This, combined with section 171(2), prevents the purchaser of an entity indirectly obtaining access to these tax attributes.

282. Section 171(2) denies the carry forward of certain tax attributes of an entity under the payments basis income tax where a change in ownership of the entity occurs. The provision also applies to the carry back of tax attributes, where that is possible. The tax attributes described in section 171(2) are self-explanatory. Section 171(1) and (2) may apply in tandem, e.g. where section 171(1) causes the realisation of a loss that is not available to be carried forward by reason of section 171(2)(a). Section 171(3) applies the rules in section 171(2) to parts of tax years.
283. Section 172 is also of an anti-abuse nature. It is primarily targeted at the indirect removal of profits from an entity in a manner that avoids taxation that would occur if the profits were distributed, e.g. the final withholding tax on dividends. This might occur, e.g. where a foreign parent sells shares in a domestic subsidiary (with retained profits) to another resident company (the "acquirer"). The acquirer may try to remove the profits exempt from tax by reason of section 142(2), discussed above at paragraphs 245 and 246. Further, the foreign parent will not be subject to tax on a transactional basis with respect to any gain on the shares realised. The shares will not be "domestic assets" as defined in section 76, so the gain will not have a domestic source by reason of section 68(3)(a), and, therefore, the gain will not be included in the parent's assessable income under section 15(1)(b). Such a scheme would only result in deferral of the dividend tax since the dividend tax would be levied whenever the subsidiary's profits were ultimately redistributed to a shareholder not entitled to the benefit of section 142(2). However, as the distribution is likely to cause the value of the shares in the subsidiary to drop, there is also the potential for the acquirer to throw up a loss by disposing of the shares post distribution.
284. Section 172 addresses this situation by treating the payment by the acquirer to the foreign parent for the shares in the subsidiary as a distribution of dividends by the subsidiary to the parent. Such a payment would, therefore, give rise to a final withholding tax liability. This treatment will also reduce the outgoings of the acquirer for the shares in the subsidiary, removing the potential for any loss where those shares are further realised by the acquirer.
285. Sections 173 and 174 provide rules that seek to restrict arbitrage that might otherwise occur due to the dual application of the transactional basis income tax and its

interaction with the payments basis income tax where entities are involved. In particular, it is targeted at the shifting of value between assets and liabilities held in an entity by persons who are associates of the entity. Value shifting may occur in other cases, e.g. the cancelling of one direct interest in an asset that causes another direct interest in the asset held by an associated person to increase in value. This form of value shifting does not involve an entity and is not specifically dealt with by the Sample. Rather, it is viewed as an issue of identifying a transfer and, therefore, a payment. The cancellation will effect a transfer of the person's interest in the asset to the associate. Section 94(1) will typically provide market value treatment for such a transfer. Where the transferred interest merges into the associate's existing interest, it will be a cost incurred in improving the existing interest and so included in the outgoings for the existing interest.

286. By contrast, value shifting between independent parties is viewed as an issue of allocation of payment under the Sample. For example, a person downgrades a right against a third party in return for an associate of the third party granting rights to an associate of the person. The granting of rights by the third party's associate is a payment under section 41(1)(b). Under section 60(2) the tax administration may treat the payment as made to the person in respect of the downgrade of that person's right. It would, therefore, be treated as an incoming with respect to the downgraded right. The same approach applies where the rights or liabilities are held in an entity that is not an associate of the person holding the rights. For example, the same approach would apply where an interest of a beneficiary in an entity is cancelled by the entity but a subsidiary of the entity issues an interest to an associate of the beneficiary.
287. Importantly, this treatment of value shifting cannot be avoided through the use of back-to-back arrangements with independent parties. For example, assume with respect to the last example that the subsidiary does not issue an interest to an associate of the beneficiary. Rather, a bank that is independent from the entity and its subsidiary makes an agreement with the associate of the beneficiary that in the event that the beneficiary's interest in the entity is cancelled, the bank will make a payment to the associate. The subsidiary of the entity makes a separate agreement with the bank to indemnify the bank with respect to any payment under this agreement. Under section 60(2)(c), the tax administration may look through the agreement with the bank and the indemnification of the bank and treat the payment by the bank as received by the beneficiary in respect of the cancellation of the interest in the entity. The broad anti-abuse powers in sections 62, 63, and 69 may also apply in these types of circumstances.
288. One remaining area of difficulty with respect to value shifting is the use of entities to shift value between associates. This may occur directly, i.e. where the shift in value is between various interests in a particular entity. In this case, there is no relative change in the value of the entity, only the assets and liabilities held in it. Value shifting between interests in entities of persons who are associates of the entities may also be indirect, i.e. where value is shifted out of a particular entity and into an associate of the entity or vice versa. There are two types of indirect value shift. Firstly, an indirect value shift may be a consequence of a direct value shift such as where an entity holds the interest that value

is moved to or from. Alternately, an indirect value shift may, in certain circumstances, result from an entity directly making a payment to or receiving a payment from an associate for inadequate consideration, i.e. a gift. The discussion proceeds to consider these types of direct and indirect value shifting in the context of sections 173 and 174.

289. The direct value shifting provisions in section 173 apply where an "event" occurs with respect to an asset or liability held in an entity that causes an increase or decrease in value of another asset or liability in the entity. "Event" is defined broadly in section 173(8) and essentially involves an acquisition, realisation, or part acquisition or realisation ("variation") of an asset or liability. Section 173 only applies where both assets or liabilities are held by persons who are "associates" of the entity in question, see definition of "associate" in section 107 discussed above at paragraphs 207 to 209. This ensures that the arrangements in question are not made at arm's length. Because of this, invariably the event will give rise to market value consequences for the party holding the asset or liability with respect to which the event occurs, e.g. under section 94 or 95 or, where the asset is an interest in an entity, section 169 or 170. So, for example, the issuing of a share in a company will be treated as acquired for market value or the cancelling of a share in a company will be treated as realised for market value. This treatment is appropriate and so section 173 does not apply to the asset or liability with respect to which the event occurs.
290. Section 173 only applies to the asset or liability held in the entity the value of which is increased or reduced by reason of the event. The problem is that no event has occurred with respect to this asset or liability that directly permits adjustment to its incomings or outgoings such as to ensure that the Sample applies appropriately. It may be that in many cases the general provisions of the Sample may be applied to indirectly provide an appropriate adjustment to this asset or liability, e.g. through the use of sections 60(2), 62, 63, and 69. However, there may be certain circumstances in which such an adjustment is problematic. For example, in the case of a cancellation of an interest in an entity, there is no transfer of the interest to the entity and, further, such an interest is not a "liability" of the entity, see the definition of that term in section 78. In this case there may be no payment made by the person whose interest is cancelled that can be allocated under section 60(2) to the holding of say an increased value interest in the entity. Further, the use of sections 60(2), 62, 63, and 69 require the exercise of power by the tax administration. Section 173 applies automatically. This is appropriate as section 173 encompasses some of the most likely scenarios in which value shifting will occur.
291. The adjustments required to the asset or liability into or from which value is moved are provided by section 173(2) to (7). Effectively, those provisions adjust the incomings or outgoings for the asset or liability in question. Where there is a decrease in value of an asset, the person is treated as realising part of the asset and deriving in respect of the realisation an amount equal to the reduction in value. Any net outgoings for the asset are apportioned to the part of the asset retained and the part treated as realised and so this process may result in recognition of a gain. Any loss that may result is not recognised. This is consistent with the approach in section 94. Where there is a

decrease in the market value of a liability, the person's incomings for the liability are increased by a similar amount. This process may also result in the recognition of a gain but not a loss. Where there is an increase in the market value of an asset or liability, the increase is treated as outgoings for the asset or liability.

292. Section 174 deals with indirect value shifting. It applies where an entity holds the asset or liability the incomings or outgoings for which are adjusted under section 173. It also applies to entities making gifts to or receiving gifts from associates. In either case, there is a movement of value between the entity and the associate. The difference between these two cases of indirect value shifting is that in the first case there is no actual payment to or from the entity but there is in the second case. Value is also shifted between an entity and an associate where losses are transferred under section 33(1)(c) or foreign income tax is transferred under section 200(3)(b). In order to ensure consistent treatment, "gift" is defined in section 345 to include such transfers for inadequate consideration.
293. In the second case of indirect value shifting (see above at paragraph 288), if the gift is by an entity to a beneficiary, it will typically be a distribution by the donor entity. If the gift is to an associate of a beneficiary, it may still be a distribution if the tax administration makes use of section 60(2). Section 174(1) alleviates the need for use of section 60(2) and covers decreases in value under section 173. It treats such movements in value from an entity as a distribution to associates of the entity in proportion to their interests in the entity. The reverse situation is where an entity receives a value shift, e.g. is the donee of a gift. As mentioned in the discussion of section 165 above at paragraph 269, the receipt of a gift will not be included in calculating the income of the donee under section 17(2)(f) or 18(2)(e) where the donor and the donee are associates. Rather, where the donee is an entity and the donor an associated beneficiary the gift is treated as a contribution to the capital of the entity. Section 174(3) reflects section 174(1) by treating value shifted into an entity by associates, whether under section 173 or as a result of a gift, as a contribution to capital made by associates of the entity in proportion to their interests in the entity. Effectively, this results in an upward adjustment to the outgoings for these interests.
294. Section 174(1) and (3) deal with value shifts to and from an entity by associates of the entity, irrespective of whether they are also beneficiaries of the entity. However, those provisions adjust the treatment of the beneficiaries of the entity who are also associates of the entity. Where the associated beneficiary in an entity (the "primary entity") is itself an entity (the "secondary entity"), the value shift to or from the primary entity should have a similar proportionate effect on the value of interests in the secondary entity. Adjustments similar but proportionate to those made by section 174(1) and (3) are, therefore, appropriate. These adjustments are made by section 174(2) and (4). The provisions are recurrent and so further apply where an associated beneficiary in the secondary entity is itself an entity, and so on.
295. The rules in sections 173 and 174 are complex, difficult to apply, and represent but one approach to value shifting. Many countries may not wish to adopt them but, rather,

rely totally on general anti-abuse rules. However, if entities are permitted to transfer tax attributes such as under sections 33(1)(c), 94, and 200(3)(b), value-shifting rules are of added importance. Another manner in which the issue may be addressed, if arbitrarily, is by only permitting losses under the transactional basis income tax to offset gains under that income tax. This does not prevent potential abuse through value shifting, it only focuses it in the transactional basis income tax where most, but not all, value shifting problems occur. This in turn will cause friction between the payments basis and the transactional basis income taxes. This might occur where a person has transactional basis losses. The person may attempt to turn payments basis gains into transactional basis gains in order to use the losses. Whatever approach is taken to value shifting, a tax administration should be aware of the issue and how to appropriately deal with it under the income tax law.

296. Section 175 provides special rules designed to provide the tax administration with relief where domestic source income and losses are allocated to or through non-residents under the entity provisions. As mentioned above at paragraphs 227, 238, 251, and 260, amounts allocated under sections 122 (partnerships), 133 (trusts), 148 (foreign branches), and 157 (controlled foreign companies) may retain their character in the hands of a beneficiary. Where this allocation is of, e.g. domestic source income to a non-resident, the non-resident may be required to include the amount allocated in calculating their assessable income and, therefore, required to file a return of income. This may be administratively inconvenient, particularly where such income is allocated through a number of non-resident entities. Further, where the non-resident beneficiary's tax rate is lower than the tax rate imposed on the entity from which the income is allocated, the non-resident may seek a refund of excess tax paid. This is also true of resident beneficiaries that are allocated domestic source income through non-resident entities. This scenario may also expose the tax administration to bogus claims for refunds.
297. In order to address this situation, section 175(1) overrides the sourcing rules in section 68 to treat certain domestic source income and losses that are derived or incurred through entities as having a foreign source. Section 175(1) applies in two cases. Firstly, it applies where the domestic source income or loss is derived or incurred by a non-resident person through a resident entity. The second case is where domestic source income is derived through a non-resident entity. The treatment of domestic source income as foreign source income means that it will not be included in calculating assessable income of non-resident beneficiaries. This rule does not apply to the allocation of income of partnerships, which is partly covered by section 122(5), discussed above at paragraph 229, and where the administrative inconvenience appears minimal. Section 175(2) overrides the definition of "foreign income tax" in section 345 to provide that domestic income tax paid with respect to income re-sourced under section 175(1) is treated as foreign income tax. This rule means that such domestic income tax may not be claimed as a tax credit and, therefore, may not be the subject of a refund claim. However, where a resident beneficiary is involved, foreign tax offsets may be claimed with respect to such tax under section 200, see the discussion below at paragraphs 312 to 314. Section 175(3) was discussed above at paragraph 262.

## **PART IV: SPECIAL INDUSTRIES AND OFFSETS**

298. In contrast to Part III (which provides special rules that apply to particular types of persons), Part IV provides special rules that are particular to certain types of activity, without particular reference to the type of person conducting the activity. Division I covers insurance, Division II covers retirement savings, and Division III provides special offsets for persons deriving foreign source income.

### **Division I: Insurance Business**

299. This Division contains special rules applicable to the insurance industry. It begins with section 180, which contains definitions of some central concepts for the Division. In particular, it distinguishes between "general insurance" and "investment insurance". "Investment insurance" is insurance that contains an investment aspect, i.e. where a return on the premium paid is expected. This type of insurance is broader than but includes the classic province of life insurance. "General insurance" is defined to cover other types of insurance. The following sections in Division I proceed to consider the treatment of premiums paid for insurance, the calculation of income from an insurance business, and the treatment of proceeds from insurance. The first and third of these involve the treatment of persons interacting with insurance businesses whereas the second involves the tax treatment of such businesses. The second will be considered before the first and third.

300. Section 182 provides for calculating income from a general insurance business. Premiums received in respect of insurance conducted by the business are included in calculating income from the business. This is offset by a deduction for proceeds paid in respect of such insurance. Otherwise, income from a general insurance business is calculated in the usual manner under Part II. One particular issue with respect to insurance business is the fluctuating profitability of the business. Insurance business is, arguably, subject to greater fluctuations in income and losses than many other forms of business. This issue is generally addressed through the provision for loss carry forward. However, in the case of insurance, this is often viewed as insufficient. One approach often adopted is to permit insurance businesses to accrue a tax-free reserve, e.g. through a deduction for a claims reserve. This approach is often aligned with the requirements of prudential supervision of the insurance industry.

301. A disadvantage of this approach is that it enables the insurance industry to create a pool of tax-free funds that may be invested to derive a return. No other industry is permitted to save in this manner unless the receipts in question consist of contributions of capital to business. Typically such contributions are made out of taxed funds and often this is not the case with respect to premiums paid for general insurance. In particular, the tax-free reserve approach discriminates against persons providing self-insurance because they are not permitted to create tax-free reserves. Therefore, section

182(3) addresses the volatility of insurance business in a different manner. Instead of permitting the creation of tax free reserves, general insurance businesses may not only carry forward losses but may carry them back for up to five years. The effect is similar to the reserve approach without permitting the investment of tax-free funds. Which approach is taken, if any, to the volatility of insurance business should be determined according to local considerations. The same applies to the length of the carry back period if the carry back approach is adopted.

302. By contrast, the general approach under the Sample is to treat investment insurance in a similar manner as an investment in shares of a company. This is clear from the manner in which income from an investment insurance business is calculated under section 183. As in the case of capital contributions to companies, premiums received in the course of conducting an investment insurance business are not included in calculating income from the business. Similarly, proceeds paid on insurance by such a business are not deductible. Given this treatment, there is no apparent need to make adjustments for any volatility of investment insurance business such as those made with respect to general insurance.
303. Sections 181 and 184 deal with the treatment of an insured with respect to the payment of insurance premiums and the receipt of proceeds from insurance, respectively. Section 181 states that the deductibility of premiums paid for insurance is generally determined under the general deduction provision in section 25, discussed above at paragraphs 70 to 78. A deduction would not be available for premiums paid by an individual for investment insurance of the individual because such premiums would be of a capital nature. Similarly, the general rule under section 184(1) is that the treatment of proceeds received from insurance is determined under section 66, discussed above at paragraph 137, i.e. the treatment depends on the type of event insured against. This is the treatment under the payments basis income tax.
304. The treatment under the transactional basis income tax is split. If the insurance covers a loss with respect to an asset or liability, the insurance is not viewed as an asset separate from the asset or liability, see the definition of "asset" in section 76 and the discussion above at paragraph 155. Rather, premiums paid may be treated as an outgoing for the asset or liability and the proceeds of insurance as an incoming. This will typically be the case with general insurance and is consistent with the approach taken to proceeds from insurance under the payments basis income tax. Where insurance does not cover loss with respect to an asset or liability, the insurance is an asset of itself and the premiums and proceeds may be outgoings and incomings with respect to that asset. This will often be the case with respect to investment insurance.
305. Section 184(2) also requires specific mention. It requires the calculation of any gain from investment insurance, i.e. the difference between premiums paid and proceeds received. This amount is treated in the same manner as a dividend. Therefore, where such gains are received from a resident person, they are subject to a final withholding tax at the same rate as dividends. Where received from a non-resident person, the gain is fully taxable but a foreign tax offset may be available under section 200 for any

foreign income tax paid with respect to the gain. The gain is treated in this way because the domestic country may not be sure if the funds from which the proceeds are paid have been appropriately taxed.

## **Division II: Retirement Savings**

306. This Division follows the general approach in Division I. Retirement savings is singled out for special treatment because of its importance, particularly with an increasing proportion of the population consisting of retirees and the diminishing ability or commitment of governments to appropriately provide for retirees. This is a highly political area and one that is particularly sensitive to local considerations. In the usual manner, the Sample simply provides one example of a possible approach. In many cases this approach will not be appropriate, particularly where there is heavy government involvement in the provision of benefits to retirees. The approach under this Division is standard in providing an incentive to save for retirement. This incentive takes the form of a limited exclusion from income for contributions to an approved retirement fund and exemption for income derived by such a fund but taxation of all funds removed from the fund. Therefore, the incentive is one of deferral only.
307. Section 190 distinguishes between "approved retirement funds" and "unapproved retirement funds". These phrases are defined in section 190(2) as is "retirement fund", which is defined in terms of entities exclusively engaged in accepting and investing retirement contributions in order to provide retirement payments to individuals. All retirement funds are unapproved unless they are approved by the tax administration in accordance with requirements to be prescribed by the regulations. The Sample does not provide an example of these requirements, which are likely to be highly subjective to local considerations. These requirements may include some restrictions requiring protection of funds invested with an approved fund and that retirement benefits are withheld until beneficiaries reach some uniform retirement age.
308. Section 192 provides for the tax treatment of retirement funds. Unapproved retirement funds are essentially treated in the same manner as companies and investment insurance businesses. This means that contributions to an unapproved retirement fund are not taxed to the fund and retirement payments are not deductible. Income of an unapproved retirement fund, calculated under Part II but subject to these rules, is fully taxed to the fund. By contrast, an approved retirement fund is exempt from tax. Section 192(4) removes the benefits of approved retirement fund status where such a fund ceases to be approved. The removal is in the form of income tax calculated under that provision and charged under the fourth head of section 1(1).
309. Sections 191 and 193 deal with contributions to retirement funds and retirement payments, respectively. Under sections 191(1) and 193(1) the general deductibility of these types of payments is determined under section 25. The exception is with respect to retirement payments made by a retirement fund, which are not deductible as mentioned in the last paragraph. Section 193(2) dealing with gains from an unapproved retirement

interest is in similar terms to section 184(2) and the above discussion of the latter provision at paragraph 305 is relevant.

310. The treatment of retirement contributions to and retirement payments by an approved retirement fund require further comment. Under section 191(2) an individual may claim a reduction in taxable income for retirement contributions made by the individual to such a fund. The total reduction claimed for a tax year is limited by section 191(3) to a specific amount to be prescribed by the regulations. An absolute amount limitation is viewed as more appropriate than a percentage of income limitation as high tax rate individuals disproportionately benefit from the latter approach. The level of this limitation must be adjusted to local considerations. Notably, an individual may claim the reduction in respect of retirement contributions made on behalf of a spouse. The limit provided in section 191(3) should be aggregated for spouses in order to facilitate this provision. The intention is that couples are encouraged to save for the retirement of both spouses irrespective of who in the couple derives income. The effective exemption of funds used to contribute to an approved retirement fund and the exemption of the fund is balanced by section 193(3), which provides for the taxation of retirement payments received from an approved retirement fund. Where a pay-out from an approved retirement fund takes the form of a lump sum, some bunching relief may be provided by section 5(2), discussed above at paragraphs 20 and 21.

### **Division III: Foreign Tax Offsets**

311. Section 200 provides a resident person deriving foreign source income with foreign tax offsets for foreign income tax paid by the person with respect to the income. Section 200(5) provides a person with the alternative of simply claiming a deduction for foreign income tax paid. Like personal offsets under section 115 and the medical costs offset under section 116, discussed above at paragraphs 218 to 222, foreign tax offsets directly reduce income tax payable by a person under the first head of section 1(1), see above at paragraph 17. The granting of foreign tax offsets is consistent with the principle of source country entitlement. This principle is typically recognised by countries either exempting foreign source income of residents or providing a foreign tax credit for foreign income tax paid with respect to such income. Which approach is adopted will depend on a number of factors including the contentious issue as to which approach is more efficient and local considerations. In particular, the foreign tax credit method is generally viewed as more complex and so the level of sophistication of the tax administration may be an issue in selection. In the usual manner, the Sample provides but one example of a relatively simple foreign tax credit system. The reasons why the Sample uses the word "offset" instead of "credit" were discussed above at paragraph 17.

312. Section 200(1) entitles "resident persons" to claim foreign tax offsets for "foreign income tax" paid with respect to their "taxable foreign income". "Resident person" is defined in sections 108 to 110 and was discussed above at paragraphs 210 to 212. Importantly, it includes a domestic branch of a non-resident. This means that such branches may claim foreign tax offsets in the same manner as domestic subsidiaries of

foreign parents and is consistent with their similar treatment under the Sample. "Foreign income tax" is defined in section 345 and "taxable foreign income" in section 200(7). "Taxable foreign income" is defined by reference to "foreign source income", which is essentially defined in section 68. However, "foreign source income" may have an extended meaning by reason of section 175, discussed above at paragraphs 296 and 297. Similarly, "foreign income tax" may have an extended meaning by reason of section 175.

313. As a result of these definitions, resident beneficiaries will often be able to claim foreign tax offsets with respect to income tax paid by an entity, or treated as paid by an entity. For example, this will be the case with resident's foreign branches by reason of the allocation of foreign income tax paid by such branches to their owners under section 148(4), discussed above at paragraph 251. This is because the beneficiary is treated as having paid the tax, thereby triggering the right to a foreign tax offset under section 200. This is also true in the case of a trust, provided the resident beneficiary is allocated the foreign income in the year in which it is derived under section 133(2) rather than section 133(3), see section 133(4) and (7) and the discussion above at paragraphs 238 and 239. These provisions can work in tandem to provide a foreign tax offset. For example, foreign income tax paid by a foreign branch of a resident trust will be treated as paid by the trust under section 148(4) and may further be treated as paid by a beneficiary under section 133(7). Section 200(6) ensures that the amount of any offset is included in calculating the person's taxable foreign income, i.e. it ensures gross-up. This provision is required, e.g. where a beneficiary of a trust is entitled to attributable income of the trust net of tax.
314. The effect of the treatment discussed in the last paragraph is to provide underlying foreign tax relief. Foreign income tax is not typically allocated from companies to their shareholders under the Sample. The exception is in the case of controlled foreign companies. The income of a controlled foreign company may be allocated to certain resident shareholders of the company under section 157(1). Further, foreign income tax paid by the company with respect to its income may be treated as paid by shareholders who are associates of the company under section 157(5), see discussion above at paragraph 262. The effect is again to provide underlying foreign tax relief but only with respect to shareholders who are associates of the company and only where the company in question is a controlled foreign company. All non-resident companies that have an associated resident shareholder fall within this category. As discussed above at paragraph 262, this treatment may be extended to distributions of resident companies in limited circumstances as a result of section 175(3).

315. Section 200(2) provides for the manner in which foreign tax offsets are calculated. This is done on a country-by-country basis. As discussed above at paragraph 146, this makes it necessary to specifically identify the foreign country in which income is sourced. The foreign tax offset for income sourced in a particular country is limited to the average rate of domestic income tax payable by the person for the tax year in question. This rate is calculated under section 200(7). The country-by-country limitation is designed to minimise any incentive to invest in low-tax countries in order to

use up excess foreign income tax paid to high-tax countries. As with many other issues, this limitation should be adjusted to local considerations.

316. Section 200(3) provides some relief from the restrictive manner in which foreign income tax may be used as a result of section 200(2). Firstly, it permits excess foreign income tax (i.e. excess resulting from the limitation in section 200(2)) to be carried forward for use in future tax years in a similar manner to excess losses under section 33, i.e. subject to a country-by-country limitation. Further, a person may transfer excess foreign income tax to an associate of the person subject to the country-by-country limitation and the requirements of section 200(4). These requirements are essentially the same as those required for the transfer of losses under section 33(3) and the discussion above at paragraphs 93 to 95 is relevant. As mentioned above at paragraph 42, this is the last of the three manners in which tax attributes may be transferred between an entity and an associate under the Sample. The overall treatment of excess foreign income tax is consistent with the treatment of excess losses subject to one exception. The restriction on the set off of investment losses against business income, discussed above at paragraph 92, is not reflected in the treatment of excess foreign income tax. The reasons for this restriction, discussed at paragraphs 35 to 39, do not appear as pertinent in the case of excess foreign income tax.

## **PART V: TAX PAYMENT PROCEDURE**

317. This Part and Part VI are what are conventionally considered the tax administration provisions. These provisions may be structured along a number of logical lines and the one adopted by the Sample is just one example. Part V contains what is referred to as the "Tax Payment Procedure". It is an effort to bring together most all administrative provisions involving the payment of tax. "Tax" in this sense must be understood in the broad context defined in section 205, which includes not just income tax but also interest, penalties, and certain other payments in the context of recovering tax. By contrast, Part VI is concerned with administration of the Sample by the tax administration authority.

318. Part V is structured under six divisions. The Part follows the common approach in the Sample of beginning with a central concepts division, in this case entitled "General Obligations". Division I sets out general obligations regarding the payment of tax, including the method and timing of payment. The following divisions largely follow the process of paying tax. Division II begins with the earliest point at which income tax may be payable during a tax year, i.e. by withholding from payments. Division III continues with the next point of payment, which is by instalment. Division IV deals with the traditional income tax payment procedure, i.e. on assessment. Division V continues by considering the consequences of non-compliance with the income tax payment procedure. In particular, it deals with interest and penalties, offences, and various methods of recovery of tax. Importantly, many of the provisions in this Division give rise to a tax, though not income tax, liability. Finally, Division VI deals with remission and refund of tax.

## **Division I: General Obligations**

319. Section 205 is the central provision in the Sample regarding payment of tax. It begins by defining "tax". As mentioned above at paragraph 317, this includes not only income tax but other amounts considered tax under the Sample such as interest, penalties, and certain other amounts. This approach is important because it ensures that the interest, penalty, and recovery provisions all apply to these amounts. Section 205(2) proceeds to identify the methods by which tax is payable, including by withholding, by instalment, on assessment, and on notification. Section 205(3) requires tax to be paid in the form and at the place prescribed by the tax administration.
320. Section 206 deals with timing the payment of tax. The Sample makes a distinction between tax that is due and tax that is due and payable. Tax is generally due when all the events needed to give rise to a liability to pay the tax have occurred. When tax is due it is a debt owed to the government. Tax may be payable some time after it is due. The amount of time given for payment should be adjusted to local conventions. When tax is payable, the tax administration may use the recovery procedure in Division V to recover the tax. The distinction between tax due and tax due and payable is used in some of the recovery provisions where, e.g. the tax administration may secure its position with respect to tax that is due but not yet payable. Of course, this position may be secured through the granting of a more general power to the tax administration. This approach is avoided because in certain situations it may be open to abuse by the tax administration. Whether a distinction between tax due and tax due and payable is adopted is yet another issue that must be decided after accounting for local considerations. Another useful consequence of clearly identifying all payments considered tax is that one provision can be used permitting the tax administration to extend the time for payment. This permission is provided by section 206(4).
321. A general obligation imposed on persons that is a consequence of the requirement to pay tax is the requirement to maintain documentation. Documentation is required in order that the tax base may be calculated and in order that information provided to the tax administration may be audited. The documents that a person must maintain under section 207 are consistent with these purposes. The length of time for which documents must be maintained and the language in which they must be kept are issues for local consideration. Often the length of time coincides with that provided by a general statute of limitations.

## **Division II: Income Tax Payable by Withholding**

322. This Division requires withholding of tax from certain payments that have a domestic source. The "source" of a payment is determined in accordance with section 68, discussed above at paragraphs 140 to 146. The obligation to withhold is generally only imposed on resident payers. However, under section 213 a non-resident person

may elect to withhold under this Division. A non-resident person may make this election in order to make the further election under section 222(3) that certain payments received by the person are not final withholding payments. This further election will mean that non-resident persons can claim deductions in order to reduce their tax liability with respect to what would otherwise be final withholding payments. This was discussed above at paragraph 85. The distinction between "resident" and "non-resident" persons was discussed above at paragraphs 210 to 212. The treatment of domestic branches of non-residents as resident persons is again important in this regard as such branches will be required to withhold under this Division.

323. The obligation to withhold does not apply to all types of payments. It applies comprehensively to payments for services. Payments by an employer to be included in calculating the income of an employee are subject to withholding under section 210. Importantly, all forms of payments of this type are covered, including in-kind payments. The Sample takes the approach that if an employer, or any other person liable to withhold tax under the Division, makes an in-kind payment, it is up to the payer to arrange with the payee how the tax is to be paid and to make that payment. The rate of tax to be withheld under section 210 is to be prescribed by the regulations. These rates are often outlined in tables and, in the context of resident employees, are adjusted for marginal tax rates and personal offsets. These rates typically permit an individual's main employer to apply the standard tax rate schedule and offsets to the individual's income from the employment.
324. Other employers and payers for services will not easily be able to identify an appropriate rate for withholding. Therefore, an arbitrary rate must be used in these cases. In the case of secondary employers, this is often equal to the highest marginal rate. The reason for this is that employees are not subject to the instalment system and there is a potential for tax deferral if tax is not withheld at a relatively high rate. By contrast, other payees for services, e.g. independent contractors, are subject to the instalment system. They will be able to credit any tax withheld during a quarter against their quarterly tax instalment. In this case the potential for deferral is substantially less and a lower rate may be viewed as appropriate. This is the approach adopted in the Sample where the rate applied to payments of service fees to residents is the same as the final withholding rate for non-resident payees, see section 212(1). As mentioned above at paragraphs 30 and 31, this is also the rate for non-resident employees with respect to their taxable income and so is the rate at which resident employers are required to withhold tax from payments to such employees.
325. Withholding is also required from investment returns as outlined in section 211. In the case of these types of payments, it is expected that a substantial amount of the payment will often remain subject to taxation on assessment even after deductions are claimed, although this will not always be the case. Further, where such payments have a domestic source and are paid to non-residents they are likely to represent wealth created or value added domestically and, on that basis, justify source based taxation, see the discussion above at paragraphs 141 and 142. For these reasons, investment returns are subject to withholding tax under the Sample. The rate selected is uniform and the

reasons for this were discussed above at paragraphs 30 and 81. Persons for whom the tax withheld is not a final withholding tax, will credit tax withheld during a quarter against their quarterly tax instalment.

326. Other payments are not subject to withholding tax. In this case, the percentage of the payment that represents value added, if any, will be unclear. Many countries do impose a general withholding tax at a low rate on all contract payments. However, inevitably there is a dispute as to the rate of this withholding tax and how it applies in the context of non-resident payees. The approach taken in the Sample is to give the tax administration power to require withholding from contract payments to non-residents in specific cases, see section 212(2). For example, this power may be used with respect to insurance premiums paid by residents to non-resident insurers. Otherwise, the Sample relies on the tax instalment system with respect to contract payments. Particularly in a domestic context, it is felt that tax administration resources are better allocated to robust enforcement of a tax instalment system, that can be seen to be fair, rather than an arbitrary withholding tax that is difficult to enforce and justify. Further, greater reliance on the tax instalment system, which must be enforced in any case, simplifies withholding requirements for payers.
327. Another manner in which the withholding system is simplified is by providing uniform rates of withholding. The more rates applied to different types of payments and payees the more difficult it is for the payer who must make the distinctions in order to correctly withhold. The obvious example is where a payer must determine the residence of a payee in order to determine the appropriate rate of withholding. Another method of simplifying the withholding tax system is to exclude from its ambit persons acting in a private capacity. Therefore, individuals making payments outside the conduct of a business are not required to withhold tax. This is another area in which resources may be better allocated to enforcing the instalment system than to enforcing the withholding system on persons who may have difficulty understanding and complying with that system.
328. Section 220 moves to the administration side of withholding. Again, it is emphasised that the Sample provides but one approach to withholding. The withholding procedure is another issue that should be adjusted to local considerations, particularly with respect to issues such as the timing of reporting requirements. Section 220 requires a withholding agent, i.e. a person under an obligation to withhold under Division II, to file monthly statements with the tax administration specifying details of withholding by the agent. Importantly, tax withheld is required to be paid with the filing of the statement. If a withholding agent fails to withhold tax, they are required to pay to the tax administration the amount that they should have withheld. The withholding agent is entitled to recover any such payment from the withholdee, i.e. the person receiving the payment subject to withholding. The only circumstance in which the withholdee is liable for payment of an amount that should have been withheld is where the withholding agent both fails to withhold and does not make the payment to the tax administration as required.

329. A withholding agent is required to give the withholdee a certificate regarding amounts withheld from payments to the withholdee, see section 221. The withholdee is required to attach any such certificates received to the withholdee's return of income for the relevant tax year, see section 235(2)(c)(i). In the case of employees, these certificates are to be provided yearly, and in other cases monthly.
330. Section 222 is an important provision that identifies final withholding payments. The gross amount of these payments constitutes the tax base for income tax charged under the third head of section 1(1). As mentioned above at paragraphs 28 and 29, all dividends distributed by resident companies are final withholding payments. Further as mentioned above at paragraphs 305 and 309, gains from investment insurance and unapproved retirement interests are treated similarly. Further, all payments to non-residents that are subject to withholding are *prima facie* final withholding payments. Again, as domestic branches of non-residents are treated as resident persons, many payments to such a branch that are subject to withholding will not be final withholding payments. Further as mentioned above at paragraph 322, non-residents that make an election under section 213 to act as a withholding agent and do so may further elect that payments subject to withholding, other than dividends and similar payments, are not final withholding payments. Section 222 also defines "investment final withholding payments". This definition is particularly relevant to the limitation on deduction of certain final withholding payments under section 27, discussed above at paragraphs 80 to 86.
331. In contrast to section 222, section 223 deals with withholding tax that is not a final tax. Section 222 provides a tax credit to the withholdee for tax withheld. This tax will reduce any liability to pay tax by instalments as well as be taken into account in determining the withholdee's overall income tax liability for a tax year on assessment, see discussion below at paragraphs 332 and 333. Section 223 proceeds to ensure that any tax withheld is included in calculating the withholdee's income, i.e. gross-up. Finally, as mentioned above at paragraphs 228 and 239, the allocation rules under the partnership and trust regimes may treat tax paid by a partnership or trust "as though the tax were withheld from a payment" to a partner or beneficiary, i.e. under sections 122(4) and 133(7). In this case the partner or beneficiary will be entitled to a tax credit under section 223.

### **Division III: Income Tax Payable by Instalment**

332. This Division provides for the payment of income tax by a person by quarterly instalments during a tax year based on an estimate of the person's taxable income for the year. It co-ordinates with the payment of income tax by withholding under Division II, see above at paragraphs 324 to 327 for the interaction with the withholding tax system. Payment of tax by instalments is fundamentally different from payment of tax by withholding. Withholding requires a person's tax to be paid by a third party, whereas under an instalment system the person pays their own tax. A similarity between these

two systems is that the tax paid under them is generally adjusted at the end of the tax period, i.e. they are preliminary and typically do not involve a final payment of tax.

333. The obligation to pay income tax by instalments under section 230 does not apply to an individual who only has employment income for a tax year. Section 230(2) sets out the timing of instalment payments. This timing is based on three monthly intervals. Importantly and for the reasons mentioned above at paragraph 100, this timing varies from person to person depending on their tax year. Section 230(3) provides a basic formula for calculating the amount of an instalment. It is a progressive formula that adjusts instalments during the year, e.g. for changes in circumstances, in an attempt to ensure that the amount of tax paid by instalment by the end of a tax year is reasonably sufficient to meet the person's full tax liability for the year. Therefore, the amount of a particular instalment is adjusted for tax paid by prior instalment, tax withheld from payments that are not final withholding payments, and, in the case of individuals, any potential claim for a medical costs offset under section 116. Section 230(4) provides that instalments of an amount below a small threshold may be disregarded. This threshold must be adjusted to suit local considerations. As with withholding tax that is not final, income tax paid by instalment is credited against the instalment payer's final tax liability.
334. Section 231 provides for the estimation of tax payable by a person that is used in section 230 in calculating the person's liability to pay tax by instalments. The Sample requires a person to estimate by the time of the first instalment for a tax year the amount of tax to be payable by the person for the whole year. Many countries permit persons to use their tax liability for the previous tax year for this purpose. This approach often proves substantially inaccurate. The Sample primarily requires an actual estimate, with the potential to change an estimate during the year with consequent adjustments to the calculation of future instalments under the formula in section 230(3). The potential for tax deferral through low estimates is addressed through an interest charge under section 251. The tax administration is provided with a power to exempt a person or class of persons from providing an estimate, e.g. small taxpayers. In this case the tax administration will make the estimate for the person, which may be based on taxable income of the previous tax year. The tax administration is also given power to override an actual estimate of a person.

#### **Division IV: Income Tax Payable on Assessment**

335. As mentioned above at paragraph 332, income tax payable by withholding and instalment is only a preliminary tax liability (other than where withholding is final). This Division provides for an overall assessment of a person's income tax liability under the first head of section 1(1) for a tax year with an appropriate accounting for any tax paid by withholding or instalment. In the usual manner, it provides for the filing of a return of income with the tax administration and an assessment of that return. However, in most cases this is a deemed assessment that is only relevant for purposes of triggering

the availability of administrative review. That is, the Sample generally adopts self-assessment, with appropriate safeguards.

336. Section 235 provides for the filing of returns of income. This is a relatively straightforward provision. The time for filing, i.e. 3 months after the end of a tax year, is only an example. As discussed above at paragraph 100, this time runs from the end of the person's own tax year and not from the end of any standard tax year. This means that the tax administration will not receive all returns of income at the same time. There is no formal requirement that a return of income be prepared with any professional assistance. However, where there is such assistance, the professional must sign the return and if in disagreement with the return must provide a statement of reasons, to be attached to the return. Professionals who assist in preparing a return that is inaccurate may be liable for penalties and guilty of an offence, e.g. see sections 254 and 265. Section 235(5) gives the tax administration power to require a person to file an early return in particular circumstances. This provision must be read in light of sections 281 and 321. In particular, under section 321 the tax administration may require any person to create a document. This would enable the tax administration to require a person to prepare a return of income on behalf of another person, e.g. require an executor to prepare a return on behalf of a deceased individual.
337. Section 235 potentially requires all persons to file a return of income for a tax year, e.g. it does not include any jurisdictional limitations. Section 236 sets out the circumstances in which a return of income is not required. A person with no tax payable for a tax year under the first two heads of income tax in section 1(1) is not required to file a return of income. This will exclude from the obligation to file most non-residents as well as persons who only derive exempt income or income subject to final withholding tax and those whose tax payable is reduced to nil, e.g. through claiming personal offsets, medical costs offset, or foreign tax offsets. Section 236 also excludes an individual who only has income from one employment. As mentioned above at paragraph 18, the effect of section 1(4) is to turn wage withholding tax into a final withholding tax, although it is not formally treated as such by the Sample. Section 236(b) reflects this by not requiring individuals subject to this treatment to file a return of income.
338. Section 237 is a standard provision enabling the tax administration to extend the time for filing a return of income. The length of extension is an issue for local consideration. An example of 60 days is provided by section 237.
339. Section 240 provides for self-assessment. The filing of a return of income and even the non-filing of a return of income are treated as an assessment on the due date for the filing of the return. This deeming provision is offset by the power of the tax administration to raise assessments under sections 241 and 242. Where the tax administration makes use of these powers to raise an assessment, the person in question must be served with a notice of assessment under section 243.

340. Section 241 concerns jeopardy assessments, i.e. assessments raised in circumstances where there is concern for securing that payment of tax will be made. This provision works in tandem with section 235(5) under which the tax administration may require a person to file an early return of income. Importantly, under section 206(3)(c) the time at which tax must be paid by reason of section 241 is basically at the discretion of the tax administration. This is provided the relevant notice of assessment or notice requiring a return of income is served on the person in question. In principle but subject to general restrictions on abuse of administrative powers, it is possible for the tax administration to make a jeopardy assessment and require immediate payment of the tax assessed. If immediate payment is not forthcoming the tax administration could immediately proceed to collect the amount of tax assessed under Division V. A jeopardy assessment may be final, in that it replaces the assessment that would otherwise take place at the end of a tax year, or preliminary, in which case it will be adjusted when an end of year return of income is filed.

341. Section 242 provides the tax administration with a broad power to amend assessments. This is a necessary balance to self-assessment but is common even in cases where full tax administration assessment is used. This power extends to self-assessments, jeopardy assessments, as well as assessments amended under a previous use of section 242. The tax administration may amend an assessment in a manner "consistent with the intention" of the Sample and using its "best judgement". These are the only substantive restrictions on exercise of the power. There is also a time limit restriction, which is primarily an encouragement for the tax administration to perform its duties in a timely fashion. Section 242(2) adopts a general time limit of three years but this should be adjusted to local considerations. Section 242(3) provides an exception in the case of fraud, in which case there is no time limit. Often this exception is not adopted on grounds of administrative certainty and in order to focus administrative resources on current tax liabilities. There is the usual exclusion of amendment with respect to issues that have been decided by a court.

## **Division V: Non-Compliance**

342. This relatively lengthy Division deals with the consequences of non-compliance with the tax payment procedure and the Sample in general. It is structured under five subdivisions. The first two deal with the imposition of sanctions designed to discourage non-compliance. These subdivisions are separated in order to emphasize the distinction between the civil consequences of non-compliance and the criminal consequences. Because non-compliance may give rise to both types of consequence, Subdivisions A and B follow the same format. Subdivision A provides the civil consequences. In principle, it is not concerned with punishment of a non-compliant person but, rather, seeks to remove any financial incentive for non-compliance. In cases that lack intent, this often means a penalty in the nature of interest. However, where there is intent, it is clear that the chance of not being discovered is an added financial benefit. This justifies a substantially increased penalty in cases of intentional non-compliance.

343. The interest and penalties imposed by Subdivision A are imposed by the tax administration. This is appropriate and in some ways is similar to penalties imposed under other civil relationships, e.g. penalties under a contract. By contrast, Subdivision B deals with the criminal consequences of non-compliance. It deals with punishing persons who do not comply with the tax law. This punishment should be meted out in a similar fashion to non-compliance with other laws and is clearly not an appropriate matter to be dealt with by the tax administration. It is more appropriately administered by a government agency such as the Public Prosecutor or the Ministry of Law and Justice, with the penalty being imposed by a court having jurisdiction over criminal cases.
344. Subdivisions C and D provide the tax administration with broad powers for the collection of tax, and this includes both income tax as well as interest and penalties but not fines for offences under Subdivision B. Subdivisions C and D provide for recovery from the person liable for tax as well as, in certain circumstances, third parties, respectively. Subdivision E deals with a number of provisions that have common application with respect to the other Subdivisions.

#### ***Subdivision A: Interest and Penalties***

345. The approach in this Subdivision is to adopt a minimal number of provisions under which interest and penalties may be imposed. It begins by focusing on the main obligations of a person liable to income tax and proceeds to cover aggravated non-compliance where intent is an element. As mentioned at paragraph 342, the intention of the interest and penalty provisions is to remove any financial incentive for non-compliance. In the case of the non-payment of tax, this goal is achieved by imposing interest at a market rate. In other cases of non-compliance, an issue is the manner in which the penalty is calculated. In order to remove the financial incentive for non-compliance, it seems that the amount of a penalty should vary depending on the amount of tax potentially at risk. In the case of a failure to file a statement or maintain records, the total amount of inclusions in calculating income multiplied by the highest marginal tax rate is used. In cases smacking with intention to reduce tax, it seems appropriate to calculate penalties by reference to the amount of tax that might have been reduced. In some cases it may be difficult to calculate this amount. Often a more arbitrary approach is adopted. However, any such approach should attempt to raise the level of penalties by reference to the amount of tax at risk.
346. Section 250 covers the failure of persons to maintain proper documentation under section 207 or to file a statement with respect to withholding, an estimate of tax payable for instalment purposes, or a return of income. A failure with respect to any of these matters may result in delay in the payment of tax. The penalty is calculated as the statutory interest rate applied to the tax at risk. As mentioned above at paragraph 84, this is the general interest rate applied throughout the Sample.

347. Section 251 provides for the imposition of interest where a person files an inaccurate estimate of tax payable for instalment purposes. The need to prevent tax deferral through underestimation of tax payable by instalments was discussed above at paragraph 334. An instalment payer is given a ten percent margin for error before interest is imposed. The interest is imposed at the statutory rate and only until such time as a return of income is to be filed. After the time for filing a return of income, section 252 takes over. It is the general provision that imposes interest for a failure to pay tax. Again the rate is the statutory rate. Section 252 applies to all "tax" as broadly defined in section 205, see the discussion above at paragraph 319. Further, interest is imposed where tax is not paid by the time it is "due and payable". This time is determined under section 206, discussed above at paragraph 320.

348. Section 253 imposes heavier penalties where a person without reasonable excuse, knowingly, or recklessly makes a misleading statement to the tax administration. This provision also applies to omissions of a similar nature. Section 254 applies to persons who knowingly or recklessly aid or abet another person to commit an offense. As mentioned above at paragraph 336, this section may have particular relevance to tax professionals providing other persons with assistance in preparing returns of income and other documentation.

349. Section 255 deals with the assessment of interest and penalties. This assessment is conducted by the tax administration. Interest and penalties under Subdivision A are not due and payable until the tax administration serves the offender with a notice of assessment, see section 206(3)(e).

### ***Subdivision B: Offences***

350. As mentioned at paragraph 342, this Subdivision broadly follows the format of Subdivision A. However, in this case the fines and imprisonment that may be imposed are not as directly influenced by the amount of tax at risk. Nevertheless, the examples of fines and imprisonment under this Subdivision do generally represent a two tiered structure that varies depending on the amount of tax at risk. The appropriate level of fine and imprisonment is subjective to local considerations and must be adjusted from the examples provided. It is important to emphasize that a court of competent jurisdiction and not the tax administration imposes the fines and imprisonment under this Subdivision. Indeed, the tax administration does not even have power to commence criminal proceedings for an offence. The Public Prosecutor or other relevant government agency must commence such proceedings but the tax administration is given specific power in section 291 to lay information regarding an offence before the Public Prosecutor. Fines are not within the definition of "tax" in section 205 and so the tax administration has no rights with respect to the collection and recovery of fines. The relevant court will have its own recovery mechanisms.

351. Section 260 is the general offence provision. It applies to all breaches of the Sample. The following provisions apply to more specific breaches. The offences in

sections 261, 262, and 265 directly reflect the application of interest and penalties under sections 252, 253, and 254, respectively. There is an additional offence in section 263 of impeding the tax administration, which may be particularly relevant where the tax administration is exercising audit powers under sections 320 and 321. Finally, section 264 provides particularly heavy fines and imprisonment for certain offences by tax officers and persons impersonating tax officers. This provision seeks to provide a clear message to tax officers that corruption at any level is not acceptable.

### ***Subdivision C: Recovery of Tax from Tax Debtor***

352. This Subdivision deals with the manner in which the tax administration may seek to recover outstanding tax directly from the person who owes the tax (the "tax debtor"). In the usual manner, it begins with a general approach and then proceeds to consider some specific options. The general approach is to sue the tax debtor. This is provided for in section 270. There will often be no need to resort to use of section 270. This is because the recovery powers granted to the tax administration under the remainder of the Subdivision and Subdivision D broadly correspond to those that courts exercise and the tax administration does not need a court order to exercise them. That is, if the tax administration cannot recover the tax under the other provisions, it is unlikely that a court would be able to recover the tax through its enforcement mechanisms. Nevertheless, in some circumstances the tax administration may wish to obtain a court order for payment of tax. For example, such an order may be required in order to bankrupt a person. This might be an appropriate action for the tax administration to take in order to assist in protecting persons that deal with insolvents.

353. Sections 271, 272, and 273 are related. The intention of these provisions is to provide the tax administration with a quick but appropriate mechanism for creating a security interest in assets of a tax debtor and the ability to realise that security through a power of sale. Sections 271 and 272 deal with situations giving rise to a security interest in favour of the tax administration and section 273 with the power of sale. Section 271 essentially provides that when a withholding agent withholds tax from a payment under Division II the tax is held in trust for the government. This ensures that the tax withheld is not generally available to the creditors of the withholding agent. If the withholding agent should not have made the payment to the withholdee, e.g. due to insolvency, the creditors must seek claw-back of the payment, e.g. under the insolvency law. Where claw-back is granted, the tax administration's claim to withheld tax will fail.

354. Section 272 enables the tax administration to create a charge over the assets of a tax debtor. Many countries seek to provide the tax administration with automatic priority over the assets of a tax debtor. This appears unfair to other creditors of a tax debtor. All creditors of a tax debtor, including the tax administration, should be treated in an even-handed manner. Typically creditors may obtain a security interest in a debtor's property through execution of a court order. As mentioned at paragraph 352, the approach under the Sample is to essentially treat a tax assessment under the Sample in the same manner as a court order for enforcement purposes. Therefore, it is consistent that the tax

administration be able to create a security interest without obtaining a court order. However, that interest in assets should be subject to prior interests obtained by third parties and the tax administration should make it clear that they have a security interest in order that other persons dealing with a tax debtor become aware of the situation.

355. To this end, in order to create a charge over a tax debtor's assets, the tax administration must serve a notice on the tax debtor. As noted above at paragraph 320, such a notice may be served where tax is due and payable by a person but also where it is only due if recovery of the tax when it becomes due and payable is at risk. Importantly, in order to protect other persons dealing with the tax debtor, section 272(4) delays the effect of a charge created by notice of the tax administration until the happening of specific events, which vary depending on the type of asset in question. In the case of land or buildings, the tax administration must apply to register the charge on the title of the property. The precise mechanics of this provision will vary from country to country. With respect to other tangible assets, the tax administration must take possession of the assets in accordance with section 273, which deals with the tax administration's power of sale. With respect to intangible assets, it is more difficult to provide the public with notice of the interest and in this case the Sample permits the charge to arise on the giving of the initial notice. Where a particular country has public registers in addition to those applying to land and buildings, e.g. with respect to company charges, it may be appropriate to require the tax administration to apply for registration before a charge becomes effective.

356. Section 273 requires the tax administration to notify the tax debtor before selling assets of the tax debtor that are charged in favour of the tax administration under section 271 or 272. This notice is in addition to but may be incorporated with a notice under section 272. Once such a notice is served with respect to tangible assets, the tax administration can take possession of the assets and may request the assistance of the police for this purpose. After taking possession the tax administration may sell or otherwise deal with the assets after waiting a set period of time, which varies depending on the type of tangible asset in question. The same applies to intangible assets without the requirement that the tax administration take possession of the assets. Section 273 also deals with the manner in which proceeds from the sale of charged assets are to be applied.

357. Section 274 provides the tax administration with power to prevent a tax debtor from leaving the country for a short period of time. This may give the tax administration time to ascertain any assets that the tax debtor has and take action with respect to them. Further, the tax administration may use this time to report the tax debtor to the Public Prosecutor in order that action can be taken with respect to any offences that may have been committed by the tax debtor.

#### ***Subdivision D: Third Party Liability***

358. This Subdivision sets out the circumstances in which one person may effectively be liable to pay tax on behalf of another person. It begins in section 280 by imposing a broad responsibility on persons involved in the management of entities for offences committed by their entities. These persons are referred to as "officers", a term defined in section 280(5). All persons who are officers of an entity when the entity commits an offence are treated as having committed the same offence. Further, where an entity fails to pay tax, every current officer of the entity or person who was such an officer within the previous six months is liable to pay the outstanding tax. The potential harshness of these rules is ameliorated by section 280(3), which provides officers with a defence. The defence is consistent with generally accepted levels of care, diligence, and skill that are expected of officers of entities. The formulation of this defence may need to be varied to reflect the local formulation of duties of officers of entities.
359. Section 281 potentially makes receivers liable for tax of the person whose assets they hold (the "tax debtor"). "Receivers" is defined broadly in section 281(5) and covers many persons who would fall within the definition of "trustee" in section 106, discussed above at paragraph 206. Section 281 is triggered by notification by the tax administration served on the receiver. In this case, the receiver must put aside the amount of tax to be paid by the tax debtor, as set out in the notice, from assets in or coming into the receiver's possession. A failure results in personal liability for the receiver.
360. Section 282 essentially grants the tax administration a power of garnishee. The tax administration may serve a notice on certain persons that are to pay amounts to a tax debtor requiring the amount to be paid to the tax administration instead. A classic use of this power involves requiring an employer to make tax payments on behalf of an employee or a bank to make tax payments on behalf of a depositor.
361. Section 283 adopts a similar approach with respect to agents of non-resident tax debtors. In this case there is no requirement that a payment to the non-resident be imminent or that the person constitute a formal agent of the non-resident. It is enough if the person is in possession of an asset of the non-resident. This power will most often be used with respect to resident agents but may have broader application. Section 283(3) contains an even stricter rule where the non-resident tax debtor is a partner of a resident partnership. In this case, the partnership and any resident partner may be made liable for tax payable by the non-resident partner irrespective of whether the partnership or resident partner holds assets of or owes money to the non-resident partner. However, the rule only applies with respect to a tax liability of the non-resident partner arising with respect to income of the partnership. This approach is consistent with treating tax liabilities with respect to partnership income as, in substance (though not in form), a partnership liability. Partners are typically jointly and severally liable for partnership liabilities.

#### ***Subdivision E: Proceedings Under Subdivisions B, C, and D***

362. This Subdivision contains a number of provisions of general application to offences and the recovery procedure. The first provision is particularly targeted at relieving courts from potentially being swamped with prosecutions for tax offences. It provides the tax administration with power to compound an offence under the Sample. As mentioned above at paragraph 343, the general approach is that the tax administration should not be involved in meting out punishment for criminal offences. Section 290 is an exception to that approach that is based on administrative convenience. Under this provision the tax administration can prevent the prosecution of a person for an offence under the Sample. In order to use the power, the offender must sign a confession in writing and pay a fine. The tax administration has no power to impose a prison sentence. Further, because the tax administration is acting in a judicial role, it must use the powers of a court to enforce any fine and not its own enforcement powers under the Sample. Due to the obvious conflict, the power to compound offences does not extend to offences under section 264, which will typically be committed by tax officers.

363. The importance of the tax administration laying information before the Public Prosecutor under section 291 was discussed above at paragraph 350. Section 292 is a standard venue provision. By contrast, section 293 requires some further explanation. Section 293(2) enables the tax administration to issue a certificate specifying the amount of tax due or due and payable by a person. It requires judicial notice of such a certificate and so saves the tax administration from having to prove tax payable by regular judicial methods.

## **Division VI: Remission and Refund**

364. The final division of Part V deals with forgiveness of a tax liability and refunds where a person has paid tax in excess of their liability. Section 300 grants the relevant minister of the government the power to remit tax. This power may only be exercised on certification by the tax administration that tax cannot be effectively collected. This secondary requirement is a standard anti-abuse mechanism. By contrast, the tax administration is given a broader power to remit penalties. This recognises that in some circumstances full adherence to the penalty regime may work unfairly.

365. Section 301 sets out the refund of tax mechanism. A refund is only available where the tax administration is satisfied that tax has been overpaid. The tax administration may exercise this power irrespective of an application by the person concerned. An application procedure is nevertheless provided in section 301(3), primarily in order to enable the administrative review provisions to operate with respect to decisions made by the tax administration on such an application. Section 301(5) requires the tax administration to pay interest on any tax refunded. This provision balances interest payable by persons who do not pay their tax on time, see discussion above at paragraph 347. The rate is the same in both instances. In practice, the interest rate payable by the tax administration is often less than that payable by taxpayers. This is an issue for local consideration.

## **PART VI: ADMINISTRATION**

366. This Part is concerned with the tax administration authority, its general powers, and administrative review of its decisions. It is structured under four divisions. Division I concerns the basic structure of the tax administration. Division II concerns official documentation under the Sample, which is generally issued or prescribed by the tax administration. Division III contains the tax administration's information collection powers. Finally, Division IV deals with review of decisions of the tax administration.

### **Division I: Officers of the Income Tax Service**

367. The Sample adopts the approach of conferring powers on the head officer of the tax administration. It is then necessary to deal with delegation of these powers to other tax officers. An alternate approach, often adopted, is to confer powers generally on the tax administration. In this case, it is necessary to limit the use of some powers to only tax officers of a certain rank. Sometimes the issue of delegation is left to the internal procedure of the tax administration. For reasons of certainty, particularly for persons dealing with tax officers using powers under the income tax law, it is preferable that at least some broad demarcation of powers is made in the income tax law. Section 305 provides but one example of such a demarcation and this issue must be adjusted to local considerations. Some countries set up the tax administration under a separate law with relative independence from the relevant ministry of the government, e.g. through a revenue board law. While this approach may have advantages, it is not adopted in the Sample.

### **Division II: Official Documentation**

368. Section 310 makes provision for amendment of the Sample by double tax treaty. In jurisdictions where treaty law overrides domestic law, this provision may not be necessary. The section makes it clear that the tax administration may assist a foreign tax administration in collecting their income tax where this is in accordance with a double tax treaty. The tax administration may use its recovery powers to collect foreign income tax in the same manner as it collects domestic income tax, see the definition of "tax" in section 205(1)(c). Section 310 provides that a double tax treaty does not override certain anti-abuse rules in the Sample. This includes the anti-treaty shopping or limitation of benefits provision in section 310(4) and (5). Depending on the status of double tax treaties under domestic law, for some countries such a limitation on the application of treaties may have no effect. This is another area where the provision must be adjusted to local considerations.

369. Section 311 provides a power to make regulations with respect to the application of the Sample. The power is broad and may be exercised with respect to virtually any issue under the Sample. Typically however, regulations may only seek to implement an

income tax law. They cannot, of themselves, make law or change the income tax law. This is why the Sample makes specific provision for making regulations with respect to particular matters that might otherwise breach this boundary.

370. Section 312 enables the tax administration to issue practice notes. These notes will set out the manner in which the tax administration intends to administer the Sample, particularly with respect to interpretation matters. In order to provide certainty to persons subject to the Sample, the tax administration is estopped from applying it in a manner contrary to that set out in a current practice note, i.e. practice notes are binding on the tax administration.
371. Section 313 enables the tax administration to issue a private ruling to a particular person with respect to tax issues arising for the person under the Sample. In the context of self-assessment, it is important that persons are able to obtain the tax administration's position on contentious issues in order to avoid the potential imposition of interest and penalties. Where a person makes full disclosure and matters proceed as disclosed, the tax administration is bound by a private ruling.
372. The remaining provisions of the Division contain some relatively self-explanatory provisions regarding documentation. Section 314 grants the tax administration a general power to specify the form of documentation under the Sample. Section 315 deals with the issuing of taxpayer identification numbers. The use of common numbers and the sharing of information across government departments and even tax offices, particularly by way of computer, is an important aspect of tax administration and collection. Section 316 deals with service of documents under the Sample. It makes provision for service of documents electronically, where the person to be served has previously agreed to this method, and in the traditional manner. Section 317 is used to determine whether a document issued under the Sample is defective and provides a method of rectification in certain circumstances.

### **Division III: Audit and Information Collection**

373. This Division grants the tax administration two broad powers for the collection of information and then seeks to impose restrictions on the use of information collected. Section 320 is very broad in granting the tax administration full and free access to premises, places, documents, and assets. This is the primary power to be used in a tax audit. The tax administration is also granted some residual powers that supplement this general access power. Tax officers must be specifically authorised to use this power of access and the occupier or other relevant person may request proof of this authorisation. Such an occupier or person may be required to provide reasonable assistance to a tax officer exercising powers under section 320. Notably, this provision does not contain any jurisdictional limitation. This issue is left to the tax administration, which should be conscious in exercising this power of potentially breaching laws of other countries. The power does not permit the tax administration to forcibly enter premises. If access is

denied to particular premises, the person denying access is guilty of an offence, e.g. under section 263, and the tax administration should seek the assistance of the police.

374. By contrast, section 321 is targeted at persons providing information rather than tax officers finding physical or electronic information. The tax administration may require a person to produce or create a specific document. There is also a direct interrogatory power whereby a person may be required to attend a particular place and be examined on oath by tax officers. As with section 320, the tax administration cannot use the power in section 321 forcibly. A non-compliant person will be guilty of an offence and remedy should be had in the criminal law. Both sections 320 and 321 purport to override the law of privilege. This means, e.g. that the tax administration may obtain access to documents in the possession of lawyers regarding their clients. The same is true of documents that are in the possession of a person and that tend to incriminate the person. Whether such an override is possible or desirable must be determined according to local considerations.

375. Section 322 is intended to balance the broad powers granted to the tax administration under sections 320 and 321. Subject to limited exceptions, tax officers may not divulge information collected in performing their duties under the Sample to any person, including a court. The main exceptions are where the divulgence is required by the officer in order to perform the officer's functions under the Sample, e.g. divulgence to other tax officers, or as a result of administrative review or other proceedings with respect to a matter under the Sample. The same secrecy requirements are imposed on a person receiving information from a tax officer under an exception to the tax officer's secrecy requirement. Breach of a secrecy requirement is viewed as a serious offence and is subject to a stiff penalty and possible imprisonment under section 264(2).

#### **Division IV: Administrative Review**

376. This Division sets up a procedure for an aggrieved person to have decisions of the tax administration under the Sample reviewed. Not all decisions of the tax administration may be reviewed under this procedure but the Division does cover most all decisions having a direct effect on the tax liability of a person. With respect to the decisions covered by the Division, this procedure replaces standard avenues of judicial review, see section 325(5). Again, such a restriction may not be possible in certain countries and the approach must be adjusted to suit local considerations. Decisions of the tax administration that are not subject to review under this procedure may be reviewed in the usual manner for judicial review of administrative action.

377. The Division is structured under three subdivisions. The first deals with an internal review by the tax administration. This will often be the most efficient manner in which to resolve disputes between the tax administration and persons subject to the income tax law. It has the potential to be relatively quick and simple and not involve the expense of court or tribunal proceedings. Subdivision B applies where the internal review by the

tax administration does not resolve the dispute. In this case the matter may initially be appealed to a specialised income tax tribunal. It is common practice to set up such a tribunal, which may be presided over by tax experts who are not necessarily lawyers and where the formalities and other restrictions of a court may be relaxed in the interests of producing efficient resolutions to income tax matters. Appeal from the tribunal to the mainstream courts is provided in the usual manner. Subdivision C provides an example of some provisions setting up an income tax tribunal (the "Income Tax Tribunal").

### ***Subdivision A: Objections***

378. Section 325 is the central provision for this Division. It sets out the decisions under the Sample that may be the subject of administrative review under the Division. The heads of reviewable decision are relatively self-explanatory and should be adjusted to suit local considerations. Access to and the timing of review depends on the "making" of a reviewable decision. The timing of such a decision is determined under section 325(2). There are some circumstances in which a person might be effectively denied review by the tax administration failing to make a decision. Therefore, section 325(3) and (4) set out certain circumstances in which a person may treat a failure by the tax administration to make a decision as a decision.

379. Section 326 incorporates the internal review procedure, i.e. an objection procedure. In order to set the procedure in motion, a person aggrieved by a reviewable decision must file with the tax administration an objection setting out the grounds on which the person objects to the decision. Importantly, the filing of an objection does not of itself effect a stay or otherwise limit the enforceability of a reviewable decision. This means that, in principle, the tax administration can proceed to collect tax in a tax assessment that is objected to. Many countries take a percentage of tax in dispute approach under which only a part of any tax in dispute must be paid. However, such an approach is potentially open to abusive delay in the payment of tax and may put recovery at risk, e.g. where the person in question is in the process of becoming insolvent. Therefore, the Sample requires full payment of tax but subject to discretion in the tax administration to stay in whole or in part the operation of a reviewable decision. The person may also seek such a stay from the Income Tax Tribunal. The objection process gives the tax administration an opportunity to reconsider the decision in question and amend the decision in any respect or disallow the objection.

### ***Subdivision B: Appeal***

380. Section 330 allows a person aggrieved by an objection decision to appeal to the Income Tax Tribunal. Similar to the effect of an objection mentioned above at paragraph 379, the filing of a notice of appeal does not stay an objection decision but the person may apply to the tax administration or the Income Tax Tribunal for such a stay. In hearing an appeal, the Income Tax Tribunal must determine the facts and make a

decision. In making a decision, the Tribunal can exercise any power available to the tax administration under the Sample, i.e. this is a review on the merits.

381. Section 331 provides an example of a further appeal from a decision of the Income Tax Tribunal to a regular court. This procedure must be adjusted to local considerations, including court rules. The provision contains a power to stay the decision appealed against, which is in a similar form to the one mentioned in the last paragraph. The court may review a decision of the Tribunal only on questions of law, e.g. the court will typically not adjust findings of fact.

### ***Subdivision C: Income Tax Tribunal***

382. As mentioned above at paragraph 377, this Subdivision provides an example of some relatively simple provisions for setting up an income tax tribunal to review decisions of the tax administration. The provisions in this Subdivision are relatively self-explanatory and the following discussion just highlights some particular features. Section 337 seeks to provide substantial flexibility as to the procedures of the Income Tax Tribunal, e.g. it is not bound by rules of evidence. The same is true of hearings of the Tribunal under section 338, e.g. an accountant is permitted to represent parties before the Tribunal. The Tribunal is required to record its proceedings and publicise them, subject to non-disclosure of confidential information, see section 339.

## **PART VII: INTERPRETATION AND CITATION**

383. This Part incorporates the general definitions section and provides for citation of the Sample. Often the general definitions section is positioned at the front of an income tax law. The Sample adopts the more direct approach of beginning with the central charging provision. Further, as explained above at paragraph 11, most of the central definitions in the Sample are incorporated into the part of the Sample to which they are most relevant. In this regard, the main purpose of section 345 is to act as a cross-referencing tool. To assist in its usability as an essential guide for navigation through the Sample, the general definitions section is placed at the end of the Sample. Many of the important definitions in section 345 have been discussed in the course of this Commentary and so further discussion of particular definitions is not pursued at this point.

## **PART VIII: TRANSITIONAL**

384. The final Part of the Sample provides an example of some basic transitional rules. These rules assume that the law to be implemented will replace an existing income tax law. Often it will not be sufficient to simply repeal the existing law and consideration should be given to the operation of particular provisions, such as the application of the interest and penalty, offence, recovery, and administrative review regimes. Further,

some of the provisions in the new law may be radically different from those in the existing law and require particular transitional rules. One example is where a country does not presently have a comprehensive transactional basis income tax, e.g. a capital gains tax. In this case, the intention is typically to tax only gains accruing after implementation of the new law. Market value outgoings are often ascribed to existing assets and market value incomings to existing liabilities in this type of case. This requires persons to value all assets and liabilities subject to the transactional basis income tax at or around the time the new law is to take effect. Another area that may require specific attention is the phasing out of concessions. The types of transitional rules required will be highly subjective to local considerations and any existing income tax law.